# STATE OF RHODE ISLAND

# EMPLOYEES' RETIREMENT SYSTEM

# FISCAL YEAR ENDED JUNE 30, 2006


Ernest A. Almonte, CPA, CFE
Auditor General

State of Rhode Island and Providence Plantations
General Assembly
Office of the Auditor General

ERNEST A. ALMONTE, CPA, CFE
*Auditor General*
ernest.almonte@oag.ri.gov

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE OF THE AUDITOR GENERAL

- *Integrity*
- *Reliability*
- *Independence*
- *Accountability*

November 20, 2006

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER William J. Murphy, Chairman

Senator Joseph A. Montalbano
Senator Dennis L. Algiere
Representative Gordon D. Fox
Representative Robert A. Watson

We have completed our audit of the financial statements of the Employees' Retirement System of the State of Rhode Island for the fiscal year ended June 30, 2006 in accordance with Chapter 36-8-19 of the Rhode Island General Laws.

Our report is contained herein as outlined in the Table of Contents and includes findings and recommendations intended to enhance controls over financial reporting and compliance with laws, regulations and contracts.

Sincerely,

Ernest A. Almonte

Ernest A. Almonte, CPA, CFE
Auditor General

***EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND***
**FISCAL YEAR ENDED JUNE 30, 2006**

## TABLE OF CONTENTS

**PAGE**

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE OF THE AUDITOR GENERAL

ERNEST A. ALMONTE, CPA, CFE
*Auditor General*
ernest.almonte@oag.ri.gov

- *Integrity*
- *Reliability*
- *Independence*
- *Accountability*

# INDEPENDENT AUDITOR'S REPORT

JOINT COMMITTEE ON LEGISLATIVE SERVICES, GENERAL ASSEMBLY
STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS:

RETIREMENT BOARD OF THE EMPLOYEES' RETIREMENT SYSTEM OF THE
STATE OF RHODE ISLAND:

We have audited the accompanying basic financial statements of the Employees' Retirement System of the State of Rhode Island (the System) as of June 30, 2006 and for the year then ended, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1(a), the financial statements present only the Pension Trust Funds of the State of Rhode Island and Providence Plantations (the State) and do not purport to, and do not, present fairly the financial position of the State, as of June 30, 2006, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net assets of the plans within the System as of June 30, 2006, and the changes in fiduciary net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 15, 2006 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis beginning on page 3 and the Schedules of Funding Progress and the Schedules of Contributions from the Employers and Other Contributing Entity on pages 30 and 31 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernest A. Almonte

Ernest A. Almonte, CPA, CFE
Auditor General

November 15, 2006

## Management's Discussion and Analysis

Management of the Employees' Retirement System of the State of Rhode Island (the System) provides this Management's Discussion and Analysis of their financial performance for the readers of the System's financial statements. This narrative provides an overview of the System's financial activity for the fiscal year ended June 30, 2006. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the System's financial activities based on the status of the System and issues currently facing management.

### Understanding the Employees' Retirement System Financial Statements

The System administers defined benefit pension plans for state employees, teachers, state police, judges and participating municipal employees. State employees and teachers are combined in one plan while state police, judges and municipal employees each have separate plans. The *Statements of Fiduciary Net Assets* provide a snapshot of the financial position of the System at June 30, 2006. The *Statements of Changes in Fiduciary Net Assets* summarize the additions and deductions that occurred during the fiscal year. The *Notes to the Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The *Required Supplementary Information* consists of schedules and related notes, which demonstrate the System's progress in accumulating funds to meet future pension benefits for members of the System.

### Financial Highlights for the Fiscal Year Ended June 30, 2006

- The System's fiduciary net assets increased by $579.4 million from $6.7 billion at June 30, 2005 to $7.3 billion at June 30, 2006.
- Total pension benefits paid to members were $607.9 million, an increase of $43.3 million or 7.67% compared to the fiscal year ended June 30, 2005.
- Total employee and employer contributions into the System's plans increased $58.5 million compared to the prior year. Total contributions from both employers and employees were $421.9 million.
- The System incurred a net gain from investing activities of $782.1 million for the fiscal year ended June 30, 2006. Included in this amount is $2.8 million in securities lending income.

## Management's Discussion and Analysis

**Assets, Liabilities and Fiduciary Net Assets (in millions)**

| | June 30, 2006 | June 30, 2005 |
|---|---|---|
| **Assets:** | | |
| Cash and cash equivalents | $ 22.0 | $ 4.6 |
| Investments | 7,271.9 | 6,700.1 |
| Contributions and other receivables | 30.8 | 38.2 |
| Due from other plans | 0.3 | 1.6 |
| Invested securities lending collateral | 1,400.4 | 1,010.6 |
| Property and equipment | 11.3 | 13.3 |
| Total assets | 8,736.7 | 7,768.4 |
| **Liabilities:** | | |
| Accounts payable | 6.8 | 6.4 |
| Due to other plans | 0.3 | 1.6 |
| Securities lending liability | 1,400.4 | 1,010.6 |
| Total liabilities | 1,407.5 | 1,018.6 |
| **Net assets**: | $ 7,329.2 | $ 6,749.8 |

**Summary of Changes in Fiduciary Net Assets (in millions)**

| | Year Ended June 30, 2006 | Year Ended June 30, 2005 |
|---|---|---|
| **Additions:** | | |
| Contributions | $ 421.9 | $ 363.4 |
| Net investment gain | 782.1 | 708.3 |
| Total Additions | 1,204.0 | 1,071.7 |
| **Deductions:** | | |
| Benefits | 607.8 | 564.6 |
| Refunds of contributions | 9.8 | 10.7 |
| Administrative expenses | 7.0 | 6.5 |
| Total Deductions | 624.6 | 581.8 |
| **Increase in Net Assets:** | 579.4 | 489.9 |
| **Net Assets:** | | |
| Beginning of year | 6,749.8 | 6,259.9 |
| End of year | $ 7,329.2 | $ 6,749.8 |

## Management's Discussion and Analysis

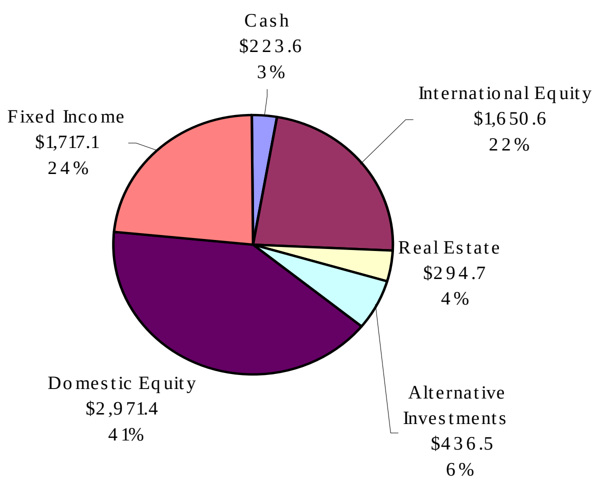
### Investments

The State Investment Commission (SIC) establishes long-term asset allocation policy and monitors investment performance of the plan. An asset/liability (A/L) study is conducted every two to three years to identify an optimal diversified investment portfolio that maximizes return within an acceptable level of risk. As long-term investors, the SIC is committed to its strategic asset allocation that has been developed as part of a comprehensive A/L study which incorporates capital market return expectations, risks and correlations associated with each asset class as well as the unique profile and objectives of the System. As a defined benefit plan, the System generally has a much longer time horizon than individual investors and is better positioned to withstand short-term volatility of the capital markets.

The following asset allocation targets were in place at June 30, 2006.

| Fiscal 2006 – Asset Allocation Targets | |
|---|---|
| Domestic Equity | 42.5% |
| International Equity | 20.0% |
| Fixed Income | 25.0% |
| Alternative Investments | 7.5% |
| Real Estate | 5.0% |

**Asset Allocation – Actual**
**Fair value (in millions) at June 30, 2006**



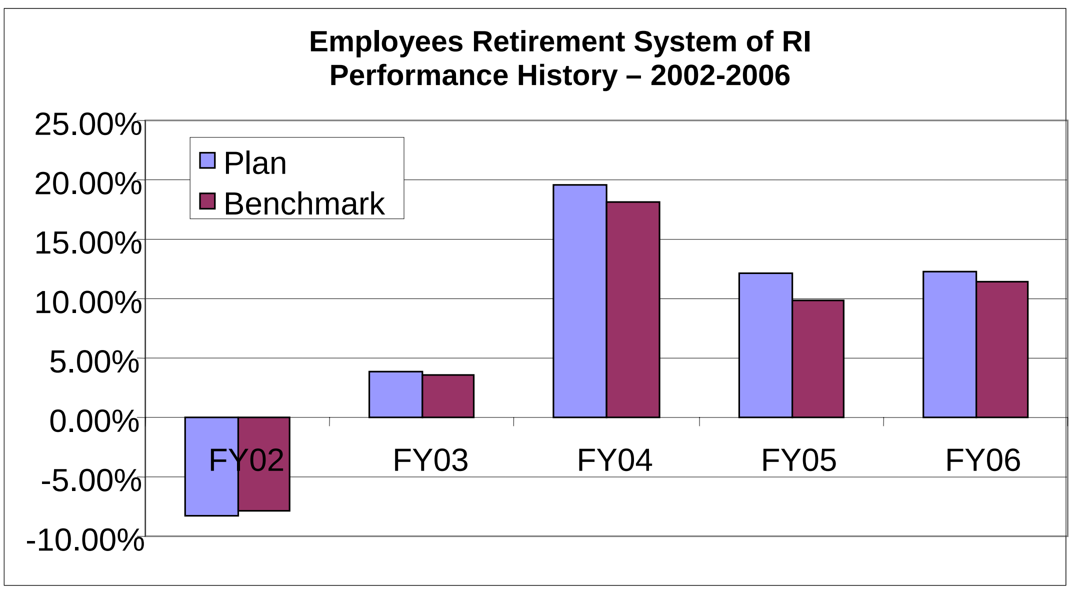

The domestic equity component includes fixed income securities as part of an enhanced equity index portfolio benchmarked to the S&P 500.

The allocation of assets among stocks, bonds and alternative investments can have a significant impact on investment performance. In light of its long time horizon, the SIC is able to take advantage of historical long-term return opportunities offered by equity investments.

## Investment Performance

The System's one-year, three-year and five-year time weighted rates of return for the periods ended June 30, 2006 were 12.6%, 14.6% and 7.5%, respectively.

Fiscal year 2006 marks the fourth consecutive year that the funds outperformed their policy benchmark. The funds total return of 12.6% for the year ended June 30, 2006 was 130 basis points above the policy benchmark of 11.3%. For the prior fiscal year, 2005, the fund beat its benchmark by a substantial 230 basis points (12.2% vs. benchmark of 9.9%). The funds outperformed the policy benchmark during fiscal 2004 by 130 basis points (19.5% vs. benchmark of 18.2%).




Equity markets around the world experienced a dramatic increase in volatility, particularly in the second quarter as investors focused on risk. The domestic markets wavered around the uncertainty of the Federal Reserve's continued rate-hiking cycle and concerns over inflation. The Federal Reserve persisted with a series of rate hikes pushing the federal funds rate to 5.25% on its 17th consecutive hike on June 29th. Non-U.S. equity markets were not immune to the volatility experienced in the United States as investors worried about the global economic slowdown. While international investors generally shied away from the more speculative emerging markets and Japan, overall, the international equity markets once again outperformed the U.S. equity markets during fiscal year 2006 with the Morgan Stanley Capital Investment all Country World Index (MSCI ACWI ex US) posting a 28.4% return and the Dow Jones Wilshire

5000 Index returning 10.0%. The bond market was flat for the year as measured by the Lehman Aggregate's -0.81% loss.

For the fiscal year ended June 30, 2006 the fund's domestic equity portfolio was up 10.3% (vs. 8.6% for the S&P 500), the international portfolio posted a 26.2% return (vs. 28.4% for the MSCI ACWI ex US) and the fixed income composite returned 0.7% (vs. -0.8% for the Lehman Aggregate). The private equity portfolio realized a gain of 26.6% on a time-weighted total return basis for fiscal 2006 and a 25.7% internal rate of return. Since inception, the private equity composite has generated an internal rate of return of 16.7%.

The System's actuarial investment return assumption is 8.25%. Actuarial value of assets is determined based on a five-year smoothing methodology.

## Funding Status

Independent actuarial valuations are conducted of the System each year. As part of this valuation, the progress toward funding pension obligations of the System is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measure is referred to as the funded ratio or funded status. As reflected in the most recent actuarial valuation (June 30, 2005), the funded ratio decreased to 56.3% for State Employees and 55.4% for Teachers within the Employees Retirement System plan. The Judges and State Police plans experienced increases in the funding ratios to 87.0% and 79.0%, respectively. The Municipal Employees Retirement System Plan's funded ratio declined with an overall average ratio of 87.2%.

Details of the funded status of each plan within the System are included in the Schedules of Funding Progress on page 30.

All employers participating in the System's plans contributed 100% of their annual actuarially required contribution.

## Economic Factors and Next Year's Contribution Rates

The System's investment portfolio experienced positive returns subsequent to June 30, 2006 consistent with the overall performance of domestic and international equity markets.

Employer contribution rates for fiscal 2007 increased for State employees (14.84% for fiscal 2006 compared to 18.40% for fiscal 2007), teachers (16.47% for fiscal 2006 compared to 19.64% for fiscal 2007), state police (31.35% for fiscal 2006 compared to 31.78% for fiscal 2007) and judges (35.51% for fiscal 2006 compared to 36.07% for fiscal 2007). The fiscal 2007 employer contribution rates are based upon an actuarial valuation performed at June 30, 2004.

**Management's Discussion and Analysis**

## Contacting the System's Management

This discussion and analysis presentation is designed to provide a general overview of the System's financial activity. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Employees' Retirement System, 40 Fountain Street, Providence, RI, 02903.

# *EMPLOYEES' RETIREMENT SYSTEM OF THE STATEOF RHODE ISLAND*
## *Statements of Fiduciary Net Assets*
## *As of June 30, 2006*

| | ERS | MERS | SPRBT | JRBT | Total *Memorandum Only* |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and cash equivalents (Note 3) | $ 20,712,778 | $ 540,788 | $ 456,182 | $ 315,963 | $ 22,025,711 |
| Receivables | | | | | |
| Contributions | 12,271,741 | 3,661,404 | - | - | 15,933,145 |
| Due from State for teachers | 12,567,666 | - | - | - | 12,567,666 |
| Due from other plans | 234,326 | 53,295 | - | - | 287,621 |
| Other | 1,819,001 | 365,548 | 10,965 | 6,755 | 2,202,269 |
| Total receivables | 26,892,734 | 4,080,247 | 10,965 | 6,755 | 30,990,701 |
| Investments at fair value (Note 3) | | | | | |
| Equity in short-term investment fund | 18,198,822 | 3,464,350 | - | - | 21,663,172 |
| Equity in pooled trust | 6,166,733,865 | 1,000,359,648 | 37,780,844 | 24,849,236 | 7,229,723,593 |
| Plan specific investments | 20,485,512 | - | - | - | 20,485,512 |
| Total investments before lending activities | 6,205,418,199 | 1,003,823,998 | 37,780,844 | 24,849,236 | 7,271,872,277 |
| Invested securities lending collateral (Note 3) | 1,195,023,630 | 193,288,623 | 7,274,705 | 4,784,720 | 1,400,371,678 |
| Property and equipment at cost net of accumulated depreciation $6,705,444 (Note 4) | 9,878,640 | 1,456,973 | 25,685 | 16,543 | 11,377,841 |
| ***Total Assets*** | 7,457,925,981 | 1,203,190,629 | 45,548,381 | 29,973,217 | 8,736,638,208 |
| **Liabilities** | | | | | |
| Securities lending liability (Note 3) | 1,195,023,630 | 193,288,623 | 7,274,705 | 4,784,720 | 1,400,371,678 |
| Accounts Payable | 5,727,831 | 1,034,525 | 25,369 | 14,665 | 6,802,390 |
| Due to other plans | 53,295 | - | 116,318 | 118,008 | 287,621 |
| ***Total Liablilities*** | 1,200,804,756 | 194,323,148 | 7,416,392 | 4,917,393 | 1,407,461,689 |
| **Net assets held in trust for pension benefits** (A schedule of funding progress for each plan is presented on page 30) | $ 6,257,121,225 | $ 1,008,867,481 | $ 38,131,989 | $ 25,055,824 | $ 7,329,176,519 |

The accompanying notes are an integral part of this financial statement.

# *EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND*
## *Statements of Changes in Fiduciary Net Assets*
## *Fiscal Year Ended June 30, 2006*

| | ERS | MERS | SPRBT | JRBT | Total *Memorandum Only* |
|---|---|---|---|---|---|
| **Additions** | | | | | |
| Contributions | | | | | |
| Member contributions | $ 141,191,643 | $ 20,727,339 | $ 886,140 | $ 564,695 | $ 163,369,817 |
| Employer contributions | 176,839,174 | 20,127,099 | 3,174,903 | 2,291,665 | 202,432,841 |
| State contribution for teachers | 54,537,733 | - | - | - | 54,537,733 |
| Interest on service credits purchased | 1,381,195 | 148,520 | - | - | 1,529,715 |
| Total contributions | 373,949,745 | 41,002,958 | 4,061,043 | 2,856,360 | 421,870,106 |
| Investment Income | | | | | |
| Net appreciation in fair value of investments | 486,453,978 | 77,178,701 | 2,728,894 | 1,789,644 | 568,151,217 |
| Interest | 76,186,906 | 12,223,820 | 435,169 | 285,754 | 89,131,649 |
| Dividends | 75,104,610 | 12,071,448 | 434,628 | 284,988 | 87,895,674 |
| Other investment income | 55,145,005 | 8,601,014 | 303,028 | 198,384 | 64,247,431 |
| | 692,890,499 | 110,074,983 | 3,901,719 | 2,558,770 | 809,425,971 |
| Less investment expense | (26,173,607) | (3,689,612) | (136,922) | (89,351) | (30,089,492) |
| Net investment income | 666,716,892 | 106,385,371 | 3,764,797 | 2,469,419 | 779,336,479 |
| Securities Lending | | | | | |
| Securities lending income | 22,975,419 | 3,835,181 | 159,834 | 105,726 | 27,076,160 |
| Less securities lending expense | (20,621,698) | (3,454,713) | (146,260) | (96,845) | (24,319,516) |
| Net securities lending income | 2,353,721 | 380,468 | 13,574 | 8,881 | 2,756,644 |
| Total net investment income | 669,070,613 | 106,765,839 | 3,778,371 | 2,478,300 | 782,093,123 |
| Miscellaneous Revenue | 49,676 | 5,089 | - | - | 54,765 |
| *Total Additions* | 1,043,070,034 | 147,773,886 | 7,839,414 | 5,334,660 | 1,204,017,994 |
| **Deductions** | | | | | |
| Benefits | | | | | |
| Retirement benefits | 422,202,906 | 39,942,459 | 144,723 | 148,928 | 462,439,016 |
| Cost of living adjustments | 106,760,817 | 5,912,116 | 4,375 | 12,062 | 112,689,370 |
| SRA Plus option | 26,887,104 | 1,522,663 | - | - | 28,409,767 |
| Supplemental benefits | 1,085,533 | - | - | - | 1,085,533 |
| Death benefits | 2,586,515 | 667,200 | - | - | 3,253,715 |
| Total benefits | 559,522,875 | 48,044,438 | 149,098 | 160,990 | 607,877,401 |
| Refund of contributions | 8,196,443 | 1,629,588 | - | - | 9,826,031 |
| Administrative expense | 6,066,456 | 867,395 | 16,293 | 10,355 | 6,960,499 |
| *Total Deductions* | 573,785,774 | 50,541,421 | 165,391 | 171,345 | 624,663,931 |
| **Net Increase** | 469,284,260 | 97,232,465 | 7,674,023 | 5,163,315 | 579,354,063 |
| **Net assets held in trust for pension benefits** | | | | | |
| **Beginning of year** | 5,787,836,965 | 911,635,016 | 30,457,966 | 19,892,509 | 6,749,822,456 |
| **End of year** | $ 6,257,121,225 | $ 1,008,867,481 | $ 38,131,989 | $ 25,055,824 | $ 7,329,176,519 |

The accompanying notes are an integral part of this financial statement.

# 1. Plan Descriptions

## (a). General

The Employees' Retirement System of the State of Rhode Island (the System) acts as a common investment and administrative agent for pension benefits to be provided for four defined benefit retirement plans as listed below:

| ***Plan Name*** | ***Type of Plan*** |
|---|---|
| Employees' Retirement System (*ERS*) | Cost-sharing multiple-employer defined benefit plan |
| Municipal Employees' Retirement System (*MERS*) | Agent multiple-employer defined benefit plan |
| State Police Retirement Benefits Trust (*SPRBT*) | Single-employer defined benefit plan |
| Judicial Retirement Benefits Trust (*JRBT*) | Single-employer defined benefit plan |

Although the assets of the plans are commingled for investment purposes, each plan's assets are accounted for separately and may be used only for the payment of benefits to the members of that plan, in accordance with the terms of that plan.

The System's financial statements are included as Pension Trust Funds within the Fiduciary Funds in the Comprehensive Annual Financial Report of the State of Rhode Island and Providence Plantations.

The System is administered by the State of Rhode Island Retirement Board which consists of 15 members: the general treasurer; the director of administration or his or her designee; the budget officer or his or her designee; the fiscal advisor to the house finance committee or his or her designee; the president of the league of cities and towns or his or her designee; two (2) active State employee members of the retirement system or officials from state employee unions to be elected by active State employees; two (2) active teacher members of the retirement system or officials from a teachers union to be elected by active teachers; one active municipal employee member of the retirement system or an official from a municipal employees union to be elected by active municipal employees; one retired member of the retirement system to be elected by retired members of the System; the chairperson of the house finance committee or his or her designee; the chairperson of the senate finance committee or his or her designee; and two (2) public representatives, one of whom shall be a C.L.U. competent in the area of pension benefits, shall be appointed by the governor and whose term shall be for four (4) years, or until their successors are appointed.

Effective July 1, 2006, legislation was enacted by the General Assembly reconstituting the make-up of the State of Rhode Island Retirement Board. The Board was authorized, created and established in the Office of the General Treasurer as an independent retirement board which shall hold and administer, in trust, the funds of the retirement system. The membership of the retirement board now consists of: the general treasurer or his or her designee who shall be a subordinate within the general treasurer's office; the director of administration or his or her designee who shall be a subordinate within the department of

# 1. Plan Descriptions (continued)

## (a). General

administration; a representative of the budget office or his or her designee from within the budget office, who shall be appointed by the director of administration; the president of the league of cities and towns or his or her designee; two (2) active state employee members of the retirement system or officials from state employee unions to be elected by active state employees; two (2) active teacher members of the retirement system or officials from a teachers union to be elected by active teachers; one active municipal employee member of the retirement system or an official from a municipal employees union to be elected by active municipal employees; two (2) retired members of the retirement system to be elected by retired members of the system; and four (4) public members, all of whom shall be competent by training or experience in the field of finance, accounting or pensions; two (2) of the public members shall be appointed by the governor, one of whom shall serve an initial term of three (3) years and one of whom shall serve an initial term of four (4) years and until his or her successor is appointed and qualified; and two (2) of the public members shall be appointed by the general treasurer, one of whom shall serve an initial term of three (3) years and one of whom shall serve an initial term of four (4) years and until his or her successor is appointed and qualified. Thereafter, the term of these four (4) public members shall be for four (4) years or until their successors are appointed and qualified by the Senate.

The System's purpose is to provide retirement benefits to state employees, public school teachers, certain general municipal employees, public safety employees, state police officers, and judges.

A summary of membership in the plans as of the June 30, 2005 actuarial valuation is listed below:

| | *Retirees and beneficiaries* | *Terminated plan members entitled to but not yet receiving benefits* | *Active Vested* | *Active Non-vested* | *Total by Plan* |
|---|---|---|---|---|---|
| **ERS** | | | | | |
| State Employees | 9,893 | 2,343 | 7,997 | 4,792 | 25,025 |
| Teachers | 8,565 | 2,015 | 7,166 | 7,303 | 25,049 |
| **MERS** | | | | | |
| General Employees | 3,553 | 1,796 | 2,840 | 4,169 | 12,358 |
| Public Safety | 373 | 77 | 590 | 654 | 1,694 |
| **SPRBT** | 2 | 1 | - | 181 | 184 |
| **JRBT** | 2 | - | 7 | 37 | 46 |
| *Total by type* | 22,388 | 6,232 | 18,600 | 17,136 | 64,356 |

# 1. Plan Descriptions (continued)

## (b). Membership and Benefit Provisions

(1) Employees' Retirement System (ERS)

The ERS was established under section two of chapter 2334 of the Rhode Island Public Laws of 1936 and placed under the management of the Retirement Board for the purpose of providing retirement allowances for employees of the State of Rhode Island under the provisions of chapters 8 to 10, inclusive, of title 36, and public school teachers under the provisions of chapters 15 to 17, inclusive, of title 16 of the Rhode Island General Laws.

The plan covers most State employees other than certain personnel at the State colleges and university (principally faculty and administrative personnel). Elected officials may become members on an optional basis. Membership in the plan is compulsory for teachers, including superintendents, principals, school nurses, and certain other school officials in the public schools in the cities and towns. Rhode Island Airport Corporation (RIAC) employees hired before July 1, 1993 are also covered and have the same benefits as State employees. Rhode Island Economic Development Corporation (RIEDC) employees who were (1) active contributing members and employees of the Department of Economic Development of the State of Rhode Island before October 31, 1995, and (2) elected to continue membership in the plan are also covered and have the same benefits as State employees. Narragansett Bay Water Quality District Commission employees who are members of a collective bargaining unit are also covered and have the same benefits as State employees.

The plan provides a two-tier benefit structure referred to as schedules A and B.

***Schedule A Benefits***

Schedule A benefits are available to members who possess 10 years or more of contributory service on or before July 1, 2005. Schedule A provides unreduced benefits of 1.7% of earnings for each of the first ten years of service; 1.9% for each of the next ten years; 3.0% per year for each of the next fourteen years; and 2% for the 35th year. Joint and survivor options are available as well as the Service Retirement Allowance (SRA) Plus option that provides for the payment of a larger benefit before the attainment of age sixty-two (62) and a reduced amount thereafter. The reduced amount is equal to the benefit before age sixty-two (62), including cost-of-living increases, minus the member's estimated social security benefit payable at age sixty-two (62). The maximum benefit is 80% of final average earnings after 35 years of service. Such benefits are available to members at least age 60 with 10 years of service, or after 28 years at any age. A different benefit formula applies to State correctional officers who may retire at age 50 if they have 20 years of service. Benefits for all employees are based on the average of the highest three consecutive years' earnings, exclusive of overtime.

# 1. Plan Descriptions (continued)

## (b). Membership and Benefit Provisions

On the third January after retirement, a cost-of-living increase of 3% (compounded annually) is provided independent of actual changes in the consumer price index. The plan also provides nonservice-connected disability benefits after five years of service; service-connected disability pensions with no minimum service requirement; vested benefits after ten years of service; survivor's benefits for service-connected death; and certain lump sum death benefits.

***Schedule B Benefits***

Schedule B benefits are provided to members who have less than 10 years of contributory service on or before July 1, 2005. For Schedule B members, the plan provides unreduced benefits of 1.6% of earnings for each of the first ten years of service; 1.8% for each of the next ten years; 2.0% per year for years 21 through 25 inclusive; 2.25% per year for years 26 through 30 inclusive; 2.50% per year for years 31 through 37 inclusive and 2.25% for the 38th year. Only single life, and joint and survivor options are available. The maximum benefit is 75% of his or her average highest three (3) years of compensation after 38 years of service. Such benefits are available to members at least age 65 with 10 years of service, or after 29 years of service and age 59. Actuarially reduced retirement is available at age 55 and 20 years of service, the benefit is reduced actuarially for each month that the age of the member is less than sixty-five (65) years.

On the month following the third anniversary date of the retirement, and on the month following the anniversary date of each succeeding year, a cost-of-living increase of 3% (compounded annually) or the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U) as published by the United States Department of Labor Statistics, determined as of September 30 of the prior calendar year, whichever is less is provided for Schedule B members.

The plan also provides benefits to legislators elected to office prior to January 1, 1995, of $600 for every year served up to a maximum of $12,000. Such benefits are available to legislators 55 and over with at least 8 years of service or, at any age with 20 or more years of service.

The plan provides a survivor benefit to public school teachers via a "Teachers Survivor Benefits Fund" in lieu of Social Security. Not all school districts participate in the plan. The cost of the benefits provided by the plan are two percent (2%) of the member's annual salary up to but not exceeding an annual salary of $9,600; one-half (1/2) of the cost is contributed by the member by deductions from his or her salary, and the other half (1/2) is contributed and paid by the respective city, town, or school district by which the member is employed. These contributions are in addition to the contributions required for regular pension benefits.

# 1. Plan Descriptions (continued)

## (b). Membership and Benefit Provisions

Spouse, parents, family and children's benefits are payable following the death of a member. A spouse shall be entitled to benefits upon attaining the age of sixty (60) years. Children's benefits are payable to the child, including a stepchild or adopted child of a deceased member if the child is unmarried and under the age of eighteen (18) years or twenty-three (23) years and a full time student, and was dependent upon the member at the time of the member's death. Family benefits are provided if at the time of the member's death the surviving spouse has in his or her care a child of the deceased member entitled to child benefits. Parents benefits are payable to the parent or parents of a deceased member if the member did not leave a widow, widower, or child who could ever qualify for monthly benefits on the member's wages and the parent has reached the age of 60 years, has not remarried, and received support from the member. In January, a yearly cost-of-living adjustment for spouse's benefits is paid and based on the annual social security adjustment.

The Teachers Survivor Benefits Fund provides benefits based on the highest salary at the time of retirement of the teacher. Benefits are payable in accordance with the following table:

| Highest Annual Salary | Spousal Monthly Minimum Benefit |
|---|---|
| $17,000 or less | $ 750 |
| $17,001 to $25,000 | $ 875 |
| $25,001 to $33,000 | $ 1,000 |
| $33,001 to $40,000 | $ 1,125 |
| $40,001 and over | $ 1,250 |

Benefits payable to children and families are equal to the spousal benefit multiplied by the percentage below:

| Parent and 1 Child | Parent and 2 Children | Parent and more than 2 Children | One Child Alone | Two Children Alone | Three or more Children Alone |
|---|---|---|---|---|---|
| 150% | 175% | 175% | 75% | 150% | 175% |

(2) Municipal Employees' Retirement System (MERS)

The MERS was established under section one of chapter 2784 of the Rhode Island Public Laws of 1951 and placed under the management of the Retirement Board for the purpose of providing retirement allowances to employees of municipalities, housing authorities, water and sewer districts, and municipal police and fire persons that have elected to participate. The plan generally provides retirement benefits equal to 2% of a member's final average salary multiplied by the number of years of total service up to a maximum of 75%. Joint and survivor options are available as well as the Service Retirement Allowance (SRA) Plus

# 1. Plan Descriptions (continued)

## (b). Membership and Benefit Provisions

option that provides for the payment of a larger benefit before the attainment of age sixty-two (62) and a reduced amount thereafter. The reduced amount is equal to the benefit before age sixty-two (62), including cost-of-living increases, minus the member's estimated social security benefit payable at age sixty-two (62). Such benefits are available to members at least age 58 with 10 years of service or after 30 years of service at any age. Police and fire personnel may retire at age 55 if they have 10 years of service or after 25 years of service at any age. An optional cost-of-living provision may be elected for police and fire personnel and general employees. An option may be elected to provide a 20 year service pension with a benefit equal to 2.5% for each year of service up to a maximum of 75% for police and fire personnel. Benefits are based on the average of the highest three consecutive years' earnings, exclusive of overtime.

The plan also provides nonservice-connected disability benefits after 5 years of service; service-connected disability pensions with no minimum service requirement; vested benefits after 10 years of service; survivor's benefits; and certain lump sum death benefits. A summary of participating employers is listed below:

| | |
|---|---|
| Municipalities, housing authorities, water and sewer districts | 68 |
| Municipal police and fire departments | 46 |
| Total participating units as of the actuarial valuation at June 30, 2005 | 114 |

(3) State Police Retirement Benefits Trust (SPRBT)

The State Police Retirement Benefits Trust was established under Rhode Island General Law Section 42-28-22.1 and was placed under the management of the Retirement Board for the purpose of providing retirement allowances to State Police.

The plan covers all State Police and Superintendents hired after July 1, 1987.

The plan generally provides retirement benefits equal to 50% of final salary after 20 years of service, plus 3.0% of final salary times service in excess of 20 years through 25 years to a maximum of 65% of final salary. Such benefits are available to members after 20 years of service regardless of age. The Superintendent of the State Police will receive 50% of his/her final salary and may retire after attainment of age 60 and 10 years of service. A cost-of-living adjustment of $1,500 per annum beginning on January 1st of the year in which a member attains his/her third anniversary of retirement is provided to all members.

Benefits are based on the final base salary earned at retirement including longevity increment, holiday pay, clothing allowance and up to 400 overtime hours.

The plan also provides nonservice-connected disability benefits after 10 years of service and service-connected disability pensions with no minimum service requirement.

# 1. Plan Descriptions (continued)

## (b). Membership and Benefit Provisions

(4) Judicial Retirement Benefits Trust (JRBT)

The Judicial Retirement Benefits Trust was established under Rhode Island General Laws 8-8.2-7; 8-3-16; 8-8-10.1; 28-30-18.1; and was placed under the management of the Retirement Board for the purpose of providing retirement allowances to Justices of the Traffic Tribunal, Supreme, Superior, Family, District and Workers Compensation courts.

The plan covers all Judges appointed after December 31, 1989.

The plan generally provides retirement benefits equal to 75% of the final salary at the time of retirement after 20 years of service, or 10 years of service and attainment of age 65. For judges appointed subsequent to July 2, 1997, salary is the average highest three (3) consecutive years of compensation. Judges retiring after 20 years of service after age 65 or 15 years of service after age 70 will receive full retirement benefits, which is the final salary at time of retirement. For judges appointed subsequent to July 2, 1997, salary is the average highest three (3) consecutive years of compensation. On the third January after the date of retirement, a cost-of-living increase amounting to 3% not compounded is provided to Supreme, Superior, Family and District Court Judges, independent of actual changes in the consumer price index. Traffic Tribunal and Workers' Compensation Court Judges, on the third January after the date of retirement, receive a cost-of-living increase amounting to 3% compounded annually.

# 2. Summary of Significant Accounting Policies

These financial statements were prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The Governmental Accounting Standards Board (GASB) is responsible for establishing generally accepted accounting principles for defined benefit pension plans established by governmental entities. In accordance with GASB Statement No. 20, in the absence of specific guidance from a GASB pronouncement, pronouncements of the Financial Accounting Standards Board (FASB) issued on or before November 30, 1989 have been followed.

**Basis of Accounting -** The financial statements of the System are prepared on the accrual basis of accounting. Under this method revenues are recorded when earned and expenses are recorded when incurred. Plan member contributions are recognized in the period in which the contributions are withheld from payroll. Employer contributions to each plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan. Dividend income is recorded on the ex-dividend date.

## 2. Summary of Significant Accounting Policies (continued)

Investment transactions are recorded on a trade date basis. The gains or losses on foreign currency exchange contracts are included in income in the period in which the exchange rates change. Gains and losses on contracts which hedge specific foreign currency denominated commitments are deferred and recognized in the period in which the transaction is completed.

**Method Used to Value Investments -** Investments are recorded in the financial statements at fair value. Fair value is the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller - that is, other than a forced liquidation sale. The fair value of fixed income and domestic and international stocks is generally based on published market prices and quotations from national security exchanges and securities pricing services. Real estate is primarily valued on appraisals by independent appraisers or as adjusted by the general partner. Commingled funds consist primarily of institutional equity index funds. The fair value of the commingled funds is based on the reported share value of the respective fund. Futures contracts are valued at the settlement price established each day by the board of trade or exchange on which they are traded. Short-term investments are stated at cost which approximates fair value. Other investments that are not traded on a national security exchange are generally valued based on audited December 31 net asset values adjusted for cash flows for the period January 1 to June 30 (which principally include additional investments and partnership distributions).

**Cash and Cash Equivalents -** Cash represents cash held in trust in a financial institution. Cash equivalents are highly liquid investments with a maturity of three months or less at the time of purchase.

**Property and Equipment –** These assets represent the Line of Business System and computer equipment recorded at cost. Depreciation is provided on a straight-line basis over the estimated useful lives, ten and five years respectfully. Depreciation of the Line of Business System commences as each stage is implemented. Property and equipment is allocated to each plan based on its proportionate share of net assets.

**Memorandum Only - Total Columns -** Total columns on the financial statements are captioned "memorandum only" to indicate that they are presented only to facilitate financial analysis. Data in these columns are not comparable to a consolidation. Inter-fund eliminations have not been made in the aggregation of this data.

# 3. Cash Deposits and Investments (continued)

## (a). Cash Deposits and Cash Equivalents

At June 30, 2006, the carrying amounts of the plans' cash deposits are listed below:

| | ERS | MERS | SPRBT | JRBT |
|---|---|---|---|---|
| Book balance | $20,712,778 | $540,788 | $456,182 | $315,963 |
| Bank balance | $21,104,983 | $566,900 | $456,182 | $315,963 |

The bank and book balances represent the plans' deposits in short-term trust accounts which include demand deposit accounts, bank money market accounts, overnight repurchase agreements and a certificate of deposit (ERS $8,500,000). Of the bank balance, $9,034,291 is covered by federal depository insurance. The remaining bank balance of $13,409,737 is fully collateralized.

In accordance with Rhode Island General Law Chapter 35-10.1, depository institutions holding deposits of the State, its agencies or governmental subdivisions of the State shall, at a minimum, insure or pledge eligible collateral equal to one hundred percent of time deposits with maturities greater than sixty days. Any of these institutions that do not meet minimum capital standards prescribed by federal regulators shall insure or pledge eligible collateral equal to one hundred percent of deposits, regardless of maturity. None of the System's deposits were required to be collateralized at June 30, 2006.

## (b). Investments

The State Investment Commission oversees all investments made by the State of Rhode Island, including those made for the System. Investment managers engaged by the Commission, at their discretion and in accordance with the investment objectives and guidelines for the System, make certain investments. The General Treasurer makes certain short-term investments on a daily basis. Rhode Island General Law Section 35-10-11 (b)(3) requires that all investments shall be made in securities as would be acquired by prudent persons of discretion and intelligence who are seeking a reasonable income and the preservation of capital.

On July 1, 1992, the State Investment Commission pooled the assets of the ERS with the assets of the MERS for investment purposes only, and assigned units to the plans based on their respective share of market value. On September 29, 1994 and November 1, 1995, the assets of the SPRBT and the JRBT, respectively, were added to the pool for investment purposes only. The custodian bank holds most assets of the System in two pooled trusts, Short-term Investment Trust and Pooled Trust. Each plan holds units in the trusts. The number of units held by each plan is a function of each plans' respective contributions to, or withdrawals from, the trust. Certain investments are not pooled and are held by only one plan (Plan specific investments).

# 3. Cash Deposits and Investments (continued)

## (b). Investments

Investment expense is allocated to each plan based on the plan's units in the Short-term Investment Fund and the Pooled Trust at the end of each month. Investment expense for plan specific investments is recorded solely in the respective plan.

The following table presents the fair value of investments by type at June 30, 2006:

| Investment Type | Fair Value |
|---|---|
| US Government Securities | $ 582,488,360 |
| US Government Agency Securities | 469,460,985 |
| Collateralized Mortgage Obligations | 43,548,080 |
| Corporate Bonds | 586,882,967 |
| International Corporate Bonds | 34,753,768 |
| Domestic Equity Securities | 1,191,377,199 |
| International Equity Securities | 1,521,896,907 |
| Foreign Currencies | 31,153,732 |
| Private Equity | 436,470,559 |
| Real Estate | 294,750,770 |
| Money Market Mutual Fund | 170,432,150 |
| Commingled Funds - Domestic Equity | 1,779,963,488 |
| Commingled Funds - International Equity | 128,693,312 |
| **Investments at Fair Value** | **$ 7,271,872,277** |
| **Securities Lending Collateral Pool** | **1,400,371,678** |
| **Total** | **$ 8,672,243,955** |

## (c). Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

Duration is a measure of a debt security's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The System manages its exposure to interest rate risk by comparing each fixed income manager portfolio's effective duration against a predetermined benchmark index based on that manager's mandate. Currently each portfolio's duration must be within +/- 20-35% of the effective duration of the appropriate index. The fixed income indices currently used by the System are:

# 3. Cash Deposits and Investments (continued)

## (c). Interest Rate Risk

- Salomon Brothers Broad Investment Grade Bond Index
- Lehman US TIPS Index
- Lehman Brothers MBS Fixed Rate Index
- CS First Boston High Yield Index
- Lehman Corporate Index

At June 30, 2006, no fixed income manager was outside of the policy guidelines.

The following table shows the System's fixed income investments by type, fair value and the effective duration at June 30, 2006:

| Investment Type: | Fair Value (in thousands) | Effective Duration |
|---|---|---|
| US Government Securities | $ 582,488 | 5.56 |
| US Government Agency Securities | 469,461 | 4.37 |
| Collateralized Mortgage Obligations | 43,548 | 3.29 |
| Corporate Bonds | 586,883 | 4.13 |
| International Corporate Bonds | 34,754 | 16.81 |
| Total Fixed Income | $ 1,717,134 | 4.92 |

The System also invested in a short-term money market mutual fund that held investments with an average maturity of 27 days. The maximum maturity of any instrument in the money market mutual fund is 13 months.

The System invests in various mortgage-backed securities, such as collateralized mortgage obligations (CMO), interest-only and principal-only (PO) strips. They are reported in U.S. Government Agency Securities and Collateralized Mortgage Obligations in the table above. CMO's are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes or tranches in accordance with the CMO's established payment order. Some CMO tranches have more stable cash flows relative to changes in interest rates while others are significantly sensitive to interest rate fluctuations. The System may invest in interest-only (IO) and principal-only strips (PO) in part to hedge against a rise in interest rates. Interest-only strips are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to pre-payments by mortgagees, which may result from a decline in interest rates. Principal-only strips receive principal cash flows from the underlying mortgages. In periods of rising interest rates, homeowners tend to make fewer mortgage prepayments.

# 3. Cash Deposits and Investments (continued)

## (d). Credit Risk

The System directs its investment managers to maintain well diversified portfolios by sector, credit rating and issuer using the prudent person standard, which is the standard of care employed solely in the interest of the participants and beneficiaries of the funds and for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the funds.

Each manager's portfolio composition is aligned with a benchmark and is constructed based on specific guidelines that are reflective of the manager's mandate. An example of a high yield fixed income manager's quidelines is as follows:

- No single industry is expected to represent more than 20% of the portfolio's market value.
- No single issue is expected to represent more than 5% of the portfolio's market value.
- The portfolio, once fully invested, is expected to include a minimum of 70 individual holdings.
- The portfolio quality is expected to be invested in high yield below investment grade fixed income securities.
- The weighted average credit quality is expected to maintain a minimum rating of "B" using either Moody's or Standard and Poor's credit ratings.

The System's exposure to credit risk as of June 30, 2006 is as follows:

| Rating | Collateralized Mortgage Obligations | US Government Agency Obligations | Corporate Bonds | International Corporate Bonds |
|---|---|---|---|---|
| Aaa | $ 28,973,956 | $ 469,460,985 | $ 81,860,437 | $ |
| Aa | 137,817 | | 46,735,747 | |
| A | 1,753,265 | | 119,567,804 | |
| Baa | 6,164,501 | | 88,011,578 | 11,034,301 |
| Ba | 473,286 | | 62,736,343 | |
| B | | | 157,043,257 | |
| Caa | | | 14,972,129 | |
| Ca | | | 429,113 | |
| C | | | 1,384,014 | |
| Not Rated | 6,045,255 | | 14,142,545 | 23,719,467 |
| Fair Value | $ 43,548,080 | $ 469,460,985 | $ 586,882,967 | $ 34,753,768 |

# 3. Cash Deposits and Investments (continued)

## (d). Credit Risk

The System's investment in a short-term money market mutual fund was unrated but held investments with an average quality rating of A-1+ / P-1.

## (e). Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a System's investments in a single issuer. There is no single issuer exposure within the System's portfolio that comprises 5% of the overall portfolio and, therefore, there is no concentration of credit risk.

## (f). Custodial Credit Risk

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. At June 30, 2006 all securities were registered in the name of the System and were held in the possession of the System's custodial bank, State Street Bank and Trust.

## (g). Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. Portfolios are diversified to limit foreign currency and security risk and the System's investment asset allocation policy targets non-US equity investments at 20%. The System may enter into foreign currency exchange contracts to minimize the short-term impact of foreign currency fluctuations on foreign investments.

# 3. Cash Deposits and Investments (continued)

## (g). Foreign Currency Risk

The System's exposure to foreign currency risk at June 30, 2006, was as follows:

| Currency | Cash | Equities | Fixed Income | Total |
|---|---|---|---|---|
| Australian Dollar | $ (52,429) | $ 89,742,842 | | $ 89,690,413 |
| Brazilian Real | | 6,589,385 | | 6,589,385 |
| Canadian Dollar | (574,780) | 68,815,361 | | 68,240,581 |
| Danish Krone | 5,546 | 645,194 | | 650,739 |
| Euro Currency | 15,262,426 | 527,160,305 | 23,719,467 | 566,142,198 |
| Hong Kong Dollar | 315,373 | 33,282,648 | | 33,598,022 |
| Hungarian Forint | 119 | 1,793,567 | | 1,793,686 |
| Indian Rupee | | 7,709,162 | | 7,709,162 |
| Indonesian Rupiah | 252,698 | 1,600,221 | | 1,852,919 |
| Japanese Yen | 3,103,267 | 291,102,128 | | 294,205,395 |
| Mexican Peso | 14,532 | 5,834,731 | 952,715 | 6,801,978 |
| New Taiwan Dollar | | 12,443,319 | | 12,443,319 |
| New Zealand Dollar | 13,488 | 5,230,159 | | 5,243,647 |
| Norwegian Krone | 11,881 | 14,490,603 | | 14,502,484 |
| Pound Sterling | 1,860,964 | 311,964,786 | | 313,825,750 |
| Russian Ruble | | 3,352,960 | | 3,352,960 |
| Singapore Dollar | 100,534 | 21,753,092 | | 21,853,626 |
| South African Rand | 81,495 | 6,940,741 | | 7,022,236 |
| South Korean Won | 1,755,800 | 20,644,997 | | 22,400,797 |
| Swedish Krona | 8,858,648 | 21,394,200 | 10,081,586 | 40,334,434 |
| Swiss Franc | 140,113 | 65,809,976 | | 65,950,089 |
| Thailand Baht | 4,057 | 3,596,530 | | 3,600,587 |
| Total | $ 31,153,732 | 1,521,896,907 | $ 34,753,768 | $ 1,587,804,407 |

The System also had exposure to foreign currency risk though its investment in international commingled equity funds.

## 3. Cash Deposits and Investments (continued)

### (h). Derivatives and Other Similar Investments

Some of the System's investment managers are allowed to invest in certain derivative type transactions, including forward foreign currency transactions and futures contracts. According to investment policy guidelines, derivative type instruments may be used for hedging purposes and not for leveraging plan assets.

**Forward Foreign Currency Contracts –** The System enters into foreign currency exchange contracts to minimize the short-term impact of foreign currency fluctuations on foreign investments. These contracts involve risk in excess of the amount reflected in the System's Statements of Fiduciary Net Assets. The face or contract amount in U.S. dollars reflects the total exposure the System has in that particular currency contract. By policy, no more than 25% of actively managed foreign equity securities (at fair value) may be hedged into the base currency (US Dollars). The U.S. dollar value of forward foreign currency contracts is determined using forward currency exchange rates supplied by a quotation service. Losses may arise due to changes in the value of the foreign currency or if the counterparty does not perform under the contract.

**Futures contracts –** The System uses futures to manage its exposure to the stock, money market, and bond markets and the fluctuations in interest rates and currency values. Buying futures tends to increase the System's exposure to the underlying instrument. Selling futures tends to decrease the System's exposure to the underlying instrument, or hedge other System investments. Losses may arise from changes in the value of the underlying instruments, if there is an illiquid secondary market for the contracts, or if the counterparties do not perform under the contract terms.

Through commingled funds, the System also indirectly holds derivative type instruments, primarily equity index futures. Other types of derivative type instruments held by the commingled funds include purchased or written options, forward security contracts, forward foreign currency exchange contracts, interest rate swaps and credit default swaps.

The System may sell a security they do not own in anticipation of a decline in the fair value of that security. Short sales may increase the risk of loss to the System when the price of a security underlying the short sale increases and the System is subject to a higher cost to purchase the security in order to cover the position.

## 3. Cash Deposits and Investments (continued)

### (i). Securities Lending

Policies of the State Investment Commission permit the System to enter into securities lending transactions. The System has contracted with State Street Bank & Trust Company (SSB) as third party securities lending agent to lend the System's debt and equity securities for cash, securities and sovereign debt of foreign countries as collateral at not less than 100% of the market value of the domestic securities on loan and at not less than 100% of the market value of the international securities on loan. In practice, securities on loan are collateralized at 102%. There are no restrictions on the amount of loans that can be made. The contract with the lending agent requires them to indemnify the System if the borrowers fail to return the securities. Either the System or the borrower can terminate all securities loans on demand. The cash collateral received on security loans was invested in the lending agent's short-term investment pool. At June 30, 2006 the investment pool had a weighted average maturity of 58 days and an average final maturity of 479 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. The System is not permitted to pledge or sell collateral securities received unless the borrower defaults. There were no losses during the fiscal year resulting from default of the borrowers or lending agent.

At June 30, 2006, management believes the System has no credit risk exposure to borrowers because the amounts the System owes the borrowers do not exceed the amounts the borrowers owe the System. The securities on loan at year-end were $1,381,551,261 (fair value), and the collateral received for those securities on loan was $1,407,928,257 (fair value).

## 4. Property and Equipment

Property and equipment consist of the line of business system and computer equipment at historical cost. Balances at June 30, 2006 were:

| | ERS | MERS | SPRBT | JRBT | Total |
|---|---|---|---|---|---|
| Line of Business System | $ 15,544,862 | $ 2,287,990 | $ 38,780 | $ 24,973 | $ 17,896,605 |
| Equipment | 160,074 | 25,214 | 842 | 550 | 186,680 |
| Property and Equipment | 15,704,936 | 2,313,204 | 39,622 | 25,523 | 18,083,285 |
| Accumulated Depreciation | (5,826,296) | (856,231) | (13,937) | (8,980) | (6,705,444) |
| Net Property and Equipment | $ 9,878,640 | $ 1,456,973 | $ 25,685 | $ 16,543 | $ 11,377,841 |

# 5. Contributions

Contribution requirements for plan members and employers are established pursuant to Rhode Island General Laws. Employers are required to contribute at an actuarially determined rate. Plan member contributions are fixed by statute.

## (a). Funding Policy

The funding policies, as set forth in Rhode Island General Law, Section 36-10-2 and 45-21-42 provide for actuarially determined periodic contributions to the plans. The actuarial valuation uses the Entry Age Normal actuarial cost method. Under this method, the employer contribution rate is the sum of (i) the employer normal cost rate, and (ii) a rate that will amortize the unfunded actuarial liability. The valuation is prepared on the projected benefit basis, under which the present value, at the assumed rate of return (currently 8.25 percent), of each participant's expected benefit payable at retirement or death is determined, based on age, service, gender and compensation.

The employer contributions required to support the benefits of the Plan are determined following a level funding approach, and consist of a normal contribution and an accrued liability contribution. The normal contribution is determined using the "entry age normal" method. Under this method, a calculation is made to determine the average uniform and constant percentage rate of employer contribution which, if applied to the compensation of each new participant during the entire period of his anticipated covered service, would be required in addition to the contributions of the participant to meet the cost of all benefits payable on his behalf. The unfunded accrued liability contributions are determined by subtracting the actuarial value of assets from the actuarial accrued liability and amortizing the result over a period not to exceed 30 years from June 30, 1999.

Effective July 1, 2005, the law as amended requires, in addition to the contributions provided for by the funding policy, commencing in fiscal year 2006, and each year thereafter, for each fiscal year in which the actuarially determined state contribution rate for state employees and teachers is lower than that for the prior fiscal year, the governor shall include an appropriation to that system equivalent to twenty percent (20%) of the rate reduction to be applied to the actuarial accrued liability. The amounts to be appropriated shall be included in the annual appropriation bill and shall be paid by the general treasurer into the retirement system. The retirement system's actuary shall not adjust the computation of the annual required contribution for the year in which supplemental contributions are received; such contributions once made may be treated as reducing the actuarial liability remaining for amortization in the next following actuarial valuation to be performed.

# 5. Contributions

## (b). Contributions

Employer contribution rates for fiscal 2006 were developed based on an actuarial valuation performed as of June 30, 2003. The table below displays the contribution rates for the year ending June 30, 2006:

| Plan | Employee | Employer |
|---|---|---|
| **ERS** | | |
| State Employees | 8.75% | 14.84% |
| Teachers | 9.50% | |
| *Municipal funded* | | 9.72% (9.05*% for towns not participating in the 1990 early retirement incentive*) |
| *State funded* | | 6.75% (6.31*% for towns not participating in the 1990 early retirement incentive*) |
| **MERS** | | |
| General Employees | 6.00% (additional 1% with a cost-of-living adjustment) | 68 Municipalities, housing authorities, water and sewer districts contributed various actuarially determined rates. |
| Public Safety | 7.00% (additional 1% with a cost-of-living adjustment and /or 1% with a 20 year service plan), Cranston Police and Cranston Fire are contributing 10% due to special plan provisions | 46 Municipal police and fire departments contributed various actuarially determined rates. |
| **SPRBT** | 8.75% | 31.35% |
| **JRBT** | 8.75% | 35.51% |

# 6. Administrative Expenses

Pursuant to General Law section 36-8-10.1, administrative costs of the System are financed through investment earnings up to a maximum of .175% of the average total investments before lending activities as reported in the annual report of the Auditor General for the next preceding five (5) fiscal years. Such amounts are transferred to a restricted receipt account within the State's general fund. Any unencumbered funds on June 30 of any fiscal year are credited to the plans in the same proportion as their contributions to the restricted receipt account.

## 7. Post-Employment Health Care Benefits

In accordance with the General Laws, post-employment health care benefits are provided to State employee members of the ERS plan who retire on or after July 1, 1989. The benefits in general cover medical and hospitalization costs for pre-Medicare retirees and a Medicare supplement for Medicare eligible retirees. The State's share of the costs of these benefits ranges from 50% for retirees with 10-15 years of service to 100% for retirees with 35 years of service. These benefits are provided on a pay-as-you-go basis and are not accounted for as part of the Employees' Retirement System. The financial activity related to post-employment benefits for state employees is reflected in the State's Health Insurance internal service fund.

## 8. Commitments

The State Investment Commission has committed to fund certain alternative investment managers at a predetermined subscription amount. Outstanding unfunded investment commitments at June 30, 2006 totaled $464.6 million. These commitments will be funded through cash available within the pooled investment trust generated through investment income and/or liquidation of other investments.

## 9. Subsequent Events

In November 2005, the System obtained title to commercial real estate located in Providence, Rhode Island as a result of bankruptcy foreclosure proceedings in the U.S. Bankruptcy Court. The System held a first lien on the commercial real estate owned by an obligor of a mortgage loan receivable previously held as a plan specific investment. In January 2006, the System leased the premises to a corporation pursuant to a three-year operating lease. In August 2006, the System sold the real estate for $20 million.

The mortgage loan receivable previously held as a plan specific investment was guaranteed by the Rhode Island Economic Development Corporation (RIEDC) to the extent of $3 million. The System has requested payment of the guarantee by RIEDC to the extent of its incurred loss related to the default on the mortgage note receivable and liquidation of the real estate obtained through foreclosure. Payment of the guarantee by RIEDC is dependent upon appropriation by the Rhode Island General Assembly.

# Employees' Retirement System of the State of Rhode Island

## *Required Supplementary Information*

# EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

***REQUIRED SUPPLEMENTARY INFORMATION***

***Schedules Of Funding Progress***

| Actuarial Valuation Date | Actuarial Value of Assets (a) | Actuarial Accrued Liability (AAL) - Entry Age - (b) | Unfunded AAL (UAAL) (b - a) | Funded Ratio (a / b) | Covered Payroll (c) | UAAL as a Percentage of Covered Payroll ((b - a) / c) |
|---|---|---|---|---|---|---|
| **ERS (*State Employees*)** | | | | | | |
| 6/30/2005 | $ 2,163,391,323 | $ 3,843,518,875 | $ 1,680,127,552 | 56.3% | $ 606,474,789 | 277.0% |
| 6/30/2004 | 2,202,900,345 | 3,694,787,818 | 1,491,887,473 | 59.6% | 606,087,585 | 246.2% |
| 6/30/2003 ± | 2,267,673,016 | 3,517,352,031 | 1,249,679,015 | 64.5% | 606,102,182 | 206.2% |
| 6/30/2002 | 2,353,855,871 | 3,284,126,961 | 930,271,090 | 71.7% | 586,888,754 | 158.5% |
| 6/30/2001 | 2,406,278,029 | 3,089,247,738 | 682,969,709 | 77.9% | 539,015,218 | 126.7% |
| 6/30/2000 | 2,345,319,663 | 2,874,905,547 | 529,585,884 | 81.6% | 517,632,152 | 102.3% |
| **ERS (*Teachers*)** | | | | | | |
| 6/30/2005 | $ 3,280,977,321 | $ 5,919,156,211 | $ 2,638,178,890 | 55.4% | $ 898,051,154 | 293.8% |
| 6/30/2004 | 3,340,527,073 | 5,634,195,435 | 2,293,668,362 | 59.3% | 866,532,598 | 264.7% |
| 6/30/2003 ± | 3,427,685,554 | 5,341,627,416 | 1,913,941,862 | 64.2% | 834,642,391 | 229.3% |
| 6/30/2002 | 3,553,823,995 | 4,857,003,061 | 1,303,179,066 | 73.2% | 792,015,577 | 164.5% |
| 6/30/2001 | 3,619,863,426 | 4,679,288,010 | 1,059,424,584 | 77.4% | 748,460,527 | 141.5% |
| 6/30/2000 | 3,514,399,312 | 4,359,881,262 | 845,481,950 | 80.6% | 703,201,056 | 120.2% |
| **SPRBT** | | | | | | |
| 6/30/2005 | $ 29,616,896 | $ 37,510,992 | $ 7,894,096 | 79.0% | $ 13,225,400 | 59.7% |
| 6/30/2004 | 24,767,014 | 32,689,173 | 7,922,160 | 75.8% | 11,421,880 | 69.4% |
| 6/30/2003 | 20,966,294 | 28,443,717 | 7,477,423 | 73.7% | 11,286,365 | 66.3% |
| 6/30/2002 | 17,770,149 | 23,527,125 | 5,756,976 | 75.5% | 10,933,360 | 52.7% |
| 6/30/2001 | 14,386,064 | 16,649,820 | 2,263,756 | 86.4% | 9,139,418 | 24.8% |
| 6/30/2000 | 11,336,596 | 13,917,343 | 2,580,747 | 81.5% | 8,916,914 | 28.9% |
| **JRBT** | | | | | | |
| 6/30/2005 | $ 19,347,372 | $ 22,250,728 | $ 2,903,356 | 87.0% | $ 5,684,585 | 51.1% |
| 6/30/2004 | 16,019,053 | 21,845,744 | 5,826,691 | 73.3% | 5,637,865 | 103.3% |
| 6/30/2003 | 13,270,977 | 18,435,395 | 5,164,418 | 72.0% | 5,303,153 | 97.4% |
| 6/30/2002 | 11,129,208 | 16,243,709 | 5,114,501 | 68.5% | 4,738,059 | 107.9% |
| 6/30/2001 | 9,190,325 | 12,026,257 | 2,835,932 | 76.4% | 4,092,423 | 69.3% |
| 6/30/2000 | 7,374,851 | 9,719,608 | 2,344,757 | 75.9% | 3,533,354 | 66.4% |
| **MERS** | | | | | | |
| 6/30/2005 | $ 886,964,787 | $ 1,017,254,365 | $ 130,289,578 | 87.2% | $ 265,123,725 | 49.1% |
| 6/30/2004 | 879,449,653 | 943,536,048 | 64,086,395 | 93.2% | 258,985,220 | 24.7% |
| 6/30/2003 | 885,842,533 | 879,589,065 | (6,253,468) | 100.7% | 241,201,031 | (2.6)% |
| 6/30/2002 | 907,193,399 | 814,857,497 | (92,335,902) | 111.3% | 247,613,063 | (37.3)% |
| 6/30/2001 | 895,475,425 | 758,089,758 | (137,385,667) | 118.1% | 225,827,136 | (60.8)% |
| 6/30/2000 | 885,392,216 | 710,616,311 | (174,775,905) | 124.6% | 207,834,738 | (84.1)% |

*See notes to required supplementary information.*

± Restated June 30, 2003 actuarial value after adopting Article 7, Substitute A as Amended

# EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

***REQUIRED SUPPLEMENTARY INFORMATION***

***Schedules Of Contributions From The Employers And Other Contributing Entity***

**ERS**

| Fiscal | State Employees | | Teachers (State) | | Teachers (Employers) | |
|---|---|---|---|---|---|---|
| Year Ended June 30 | Annual Required Contribution | Percentage Contributed | Annual Required Contribution | Percentage Contributed | Annual Required Contribution | Percentage Contributed |
| 2006 | $ 91,254,063 | 100% | $ 54,537,733 | 100% | $ 83,794,372 | 100% |
| 2005 | 66,087,984 | 100% | 48,834,755 | 100% | 73,006,173 | 100% |
| 2004 | 55,699,588 | 100% | 45,039,279 | 100% | 70,666,221 | 100% |
| 2003 | 45,141,250 | 100% | 38,242,690 | 100% | 55,504,739 | 100% |
| 2002 | 31,801,645 | 100% | 30,763,337 | 100% | 44,391,050 | 100% |
| 2001 | 44,540,998 | 100% | 35,365,234 | 100% | 48,153,386 | 100% |

**MERS**

| Fiscal Year Ended June 30 | Annual Required Contribution | Percentage Contributed |
|---|---|---|
| 2006 | $ 20,127,099 | 100% |
| 2005 | 13,081,956 | 100% |
| 2004 | 9,406,147 | 100% |
| 2003 | 6,485,065 | 100% |
| 2002 | 7,536,081 | 100% |
| 2001 | 6,092,688 | 100% |

**SPRBT**

| Fiscal Year Ended June 30 | Annual Required Contribution | Percentage Contributed |
|---|---|---|
| 2006 | $ 3,174,903 | 100% |
| 2005 | 2,614,503 | 100% |
| 2004 | 2,224,191 | 100% |
| 2003 | 2,256,770 | 100% |
| 2002 | 2,405,041 | 100% |
| 2001 | 1,819,930 | 100% |

**JRBT**

| Fiscal Year Ended June 30 | Annual Required Contribution | Percentage Contributed |
|---|---|---|
| 2006 | $ 2,291,665 | 100% |
| 2005 | 2,056,558 | 100% |
| 2004 | 1,830,204 | 100% |
| 2003 | 1,656,965 | 100% |
| 2002 | 1,458,093 | 100% |
| 2001 | 1,163,571 | 100% |

*See notes to required supplementary information.*

# 1. Schedules of Funding Progress

Effective with the June 30, 2003 valuation, material changes were made to the termination, payroll growth and salary increase assumptions. Changes were also made to the general mortality rates and mortality rates used for disabled lives. The disability and retirement tables were also adjusted to reflect the plan experience. Particularly, the salary increase rates for state employees were changed from 4.25% - 14.25% to 4.5% - 8.25%. The base salary increase rates were increased from 4.25% to 4.5% for all teachers and MERS General Employees, and decreased from 5.5% to 5.25% for Judges. The payroll growth rate was increased from 3.0% to 3.75% for ERS, MERS and State Police and decreased from 5.5% to 5.25% for Judges. The June 30, 2003 actuarial accrued liability was restated to reflect the amendment to the law governing benefits for state employees and teachers effective July 1, 2005 – see note 1(b) to the financial statements entitled *Plan Descriptions – Membership and Benefit Provisions*.

Effective with the June 30, 2002 valuation, the amortization period for the unfunded actuarial accrued liability for MERS was changed to 30 years from June 30, 1999 or 27 years from June 30, 2002.

Effective with the June 30, 2002 valuation, the actuarial value of assets for MERS was changed from a three-year smoothed market technique to a five-year smoothed market technique.

The MERS funded ratio is a composite of all units in the plan. The System performs a separate valuation for each unit.

# 2. Schedules of Employer Contributions

Employer contributions for the ERS plan included in the Schedules of Contributions from the Employers and Other Contributing Entity do not include Teacher Survivor Benefits as described in Note 1(b) and any employer contributions related to supplemental pension benefits that are attributable and paid by a specific employer. These amounts are not included in the annual required contribution.

The Plans began using the entry age normal cost method as the basis for determining employer costs in fiscal year 2002. The unfunded liabilities of the plans are amortized over a 30 year period from June 30, 1999. The closed period ends 30 years from June 30, 1999.

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows.

# 3. Actuarial Assumptions and Methods

| | ERS | | | | |
|---|---|---|---|---|---|
| | ***State Employees*** | ***Teachers*** | **MERS** | **SPRBT** | **JRBT** |
| Valuation Date | 6/30/05 | 6/30/05 | 6/30/05 | 6/30/05 | 6/30/05 |
| Actuarial Cost Method | Entry Age Normal | Entry Age Normal | Entry Age Normal | Entry Age Normal | Entry Age Normal |
| Amortization Method | Level Percent of Payroll – Closed | Level Percent of Payroll – Closed | Level Percent of Payroll – Closed | Level Percent of Payroll – Closed | Level Percent of Payroll – Closed |
| Equivalent Single Remaining Amortization Period | 24 years | 24 years | 24 Years | 24 years | 24 years |
| Asset Valuation Method | 5 Year Smoothed Market | 5 Year Smoothed Market | 5 Year Smoothed Market | 5 Year Smoothed Market | 5 Year Smoothed Market |
| Actuarial Assumptions | | | | | |
| Investment Rate of Return | 8.25% | 8.25% | 8.25% | 8.25% | 8.25% |
| Projected Salary Increases | 4.50% to 8.25% | 4.50% to 17.00% | *General Employees* 4.50% to 9.00% *Police & Fire Employees* 5.00% to 15.50% | 5.00% to 15.00% | 5.25% |
| Inflation | 3.00% | 3.00% | 3.00% | 3.00% | 3.00% |
| Cost of Living Adjustments | Schedule A members -3.0% compounded Schedule B members – 2.5% | Schedule A members -3.0% compounded Schedule B members – 2.5% | 3.0% Non-compounded | $1,500 per annum | 3.0% (*see Note1(b)(4)*) to the financial statements |

Schedule A - ERS members are those with 10 years or more of contributory service on or before July 1, 2005. Schedule B - ERS members are those with less than 10 years of contributory service on or before July 1, 2005. The plan provisions for Schedule A and B members are described in Note 1(b) to the financial statements entitled *Plan Descriptions – Membership and Benefit Provisions.*

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE OF THE AUDITOR GENERAL

ERNEST A. ALMONTE, CPA, CFE
*Auditor General*
ernest.almonte@oag.ri.gov

- *Integrity*
- *Reliability*
- *Independence*
- *Accountability*

# INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

JOINT COMMITTEE ON LEGISLATIVE SERVICES, GENERAL ASSEMBLY
STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS:

RETIREMENT BOARD OF THE EMPLOYEES' RETIREMENT SYSTEM OF THE
STATE OF RHODE ISLAND:

We have audited the statements of fiduciary net assets of the Employees' Retirement System of the State of Rhode Island (the System) as of June 30, 2006 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated November 15, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

## Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the System's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and recommendations as findings 2006-1 and 2006-2.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider findings 2006-1 and 2006-2 be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards* and which is described as Finding 2006-5 in the accompanying Findings and Recommendations section.

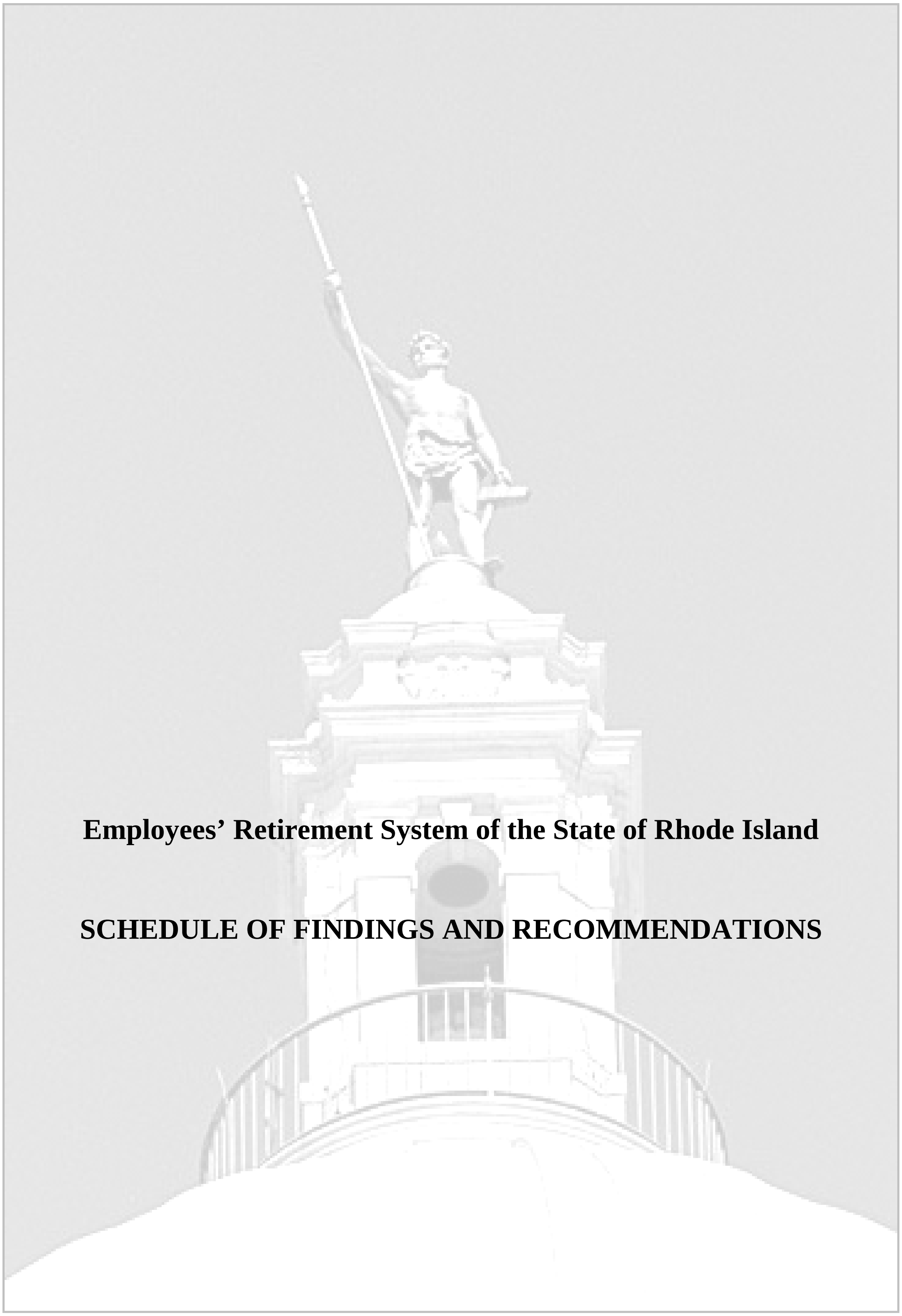
We also noted certain additional matters, as included in the accompanying Findings and Recommendations section which we reported to management of the System.

This report is intended solely for the information and use of the members of the Retirement Board, management, and the Joint Committee on Legislative Services, General Assembly, State of Rhode Island and Providence Plantations and is not intended to be and should not be used by anyone other than these specified parties.

Ernest A. Almonte

Ernest A. Almonte, CPA, CFE
Auditor General

November 15, 2006



## Employees’ Retirement System of the State of Rhode Island

## SCHEDULE OF FINDINGS AND RECOMMENDATIONS

# REPORTABLE CONDITIONS

## FINDING 2006-1

### IMPROVE CONTROLS OVER FINANCIAL REPORTING

ERSRI's process for preparing financial statements can be improved by ensuring that its accounting systems generate required financial reporting information on a timely basis and sufficient accounting personnel are in place to allow timely posting, monitoring and analysis of accounting information during the year.

***Improve the Reliability of Contributions Receivable Reported by the ANCHOR System***

ERSRI implemented a new accounting system, known as ANCHOR, during fiscal 2002, which was designed to meet both its operational and financial reporting needs. Balances reported by ANCHOR for contributions and contributions receivable, require significant analysis and adjustment to yield amounts that are appropriate for financial statements prepared in accordance with generally accepted accounting principles.

Certain of these issues involve how the system was programmed to meet various operational objectives. For example, contributions received will remain as deferred revenue until the detail contribution data passes edit checks allowing the data to post to the contribution database. From a financial reporting perspective the contributions have been "earned" and should be reflected as revenue. Similarly, the State's matching contribution for teachers is not recorded until all contribution data has passed 100% of the system edits.

When employers report their detail contribution data before remitting payment to the System, ANCHOR appropriately recognizes contributions receivable. Without actual detail contribution data, the ANCHOR system has not generated reliable estimates of contributions due the System. For financial reporting purposes, contributions should be recognized based upon employer payroll activity.

In order to improve the reliability of contributions receivable reported by ANCHOR, the System should require all participating employers to report their detail contribution data on a timely basis particularly at fiscal year end. This would allow the ANCHOR system to accurately report contributions due the system and facilitate the preparation of financial statements.

Balances reported for an employer may also be inaccurate because of posting errors that occurred in prior periods. While a modification was made to the system which allows correction of posting errors on a prospective basis, previously known errors have been tracked off-line and therefore the ANCHOR system may not report accurate current balances of contributions owed to the system. Additionally, the ANCHOR system is intended to be self-monitoring by employers, allowing them access to the system via the internet to assess the status of contributions and payments. Inaccurate employer contribution data limits the effectiveness of this system function. ERSRI is in the process of completing its analysis and reconciliation of these posting errors affecting contributions and contributions receivable.

RECOMMENDATIONS

2006-1a Require all participating employers to report detail contribution data on a timely basis, particularly at fiscal year end.

2006-1b Complete analysis and reconciliation of prior period posting errors affecting contributions and contributions receivable by employer unit.

*Auditee Views:*

*ERSRI concurs and will develop procedures and policies to expedite employer posting of contributions thereby allowing the ANCHOR system to automatically record revenue.*

*ERSRI anticipates completion of the analysis and reconciliation by the close of fiscal 2007.*

## *Adopt a Standard Closing Process and Schedule*

ERSRI has not adopted a formalized closing process which should detail required closing journal entries to be prepared at the end of the fiscal year. The standard closing process should be included in an accounting manual detailing the following information and processes:

- Data accumulation and analysis required to prepare the journal entries;
- Expected transaction flows, balances and relationships for specific accounts;
- Required journal entries including sample entries detailing specific accounts;
- Sources of data for each standard journal entry (e.g., external sources, Anchor reports, database queries, etc.);
- Frequency of posting the journal entries (e.g., annually, monthly);
- Accounting personnel responsible for preparing and approving the journal entries;
- Schedule for completion of the journal entries and closing process; and
- Required reconciliations to subsidiary detail or external data sources for certain account balances.

At June 30, 2006, ERSRI was in the process of developing an accounting manual.

RECOMMENDATION

2006-1c Complete development of an accounting manual detailing a formalized closing process including sample journal entries, data sources for the journal entries, and responsibility for initiating and approving closing entries.

*Auditee Views:*

*An accounting manual is in the process of being developed by an independent accounting firm, which is targeted for completion by December 2006.*

***Ensure Resources are Adequate to Allow Accounting Functions to be Performed Timely and Implement Effective Oversight of the Accounting and Financial Reporting Functions***

ERSRI continues to have insufficient personnel devoted to accounting functions. Vacancies in key accounting positions have existed over a period of years when ERSRI was completing implementation of its accounting system and significantly changing its operations and financial reporting processes. Currently, the Assistant Director – Finance position is vacant. Consequently, the Executive Director continues to be directly responsible for posting journal entries and preparing draft financial statements. The lack of adequate accounting resources weakened controls over financial reporting.

ERSRI has three principal activity cycles – collection of contributions, payment of benefits, and investment of assets. Accounting responsibility for the investment of assets is fragmented since a unit separate from the Retirement Division is responsible for the investment activity cycle. Investment transactions are recorded by ERSRI's custodian and reported and summarized for the System. Recording of this activity (in summary form) within the System's accounting records is only performed once at the close of the fiscal year. The growth and complexity of the System's investment portfolio warrant additional attention to the accounting and financial reporting aspects of the investment cycle. Additionally, complex investment valuation issues, disclosure of investment-related risks, the System's exposure to derivative type investments and the overall requirements of preparing financial statements in accordance with generally accepted accounting principles have increased the need for accounting resources.

Either the redistribution of accounting responsibilities or an additional accounting position should be considered to perform various accounting functions related to ERSRI system investments. These functions should include monthly recording of investment activity as reported by the custodian, reconciliation of contributions/transfers to and from the custodian, reconciliation and monitoring of custodian-generated accounting reports, monitoring and accumulation of fair value information for financial reporting purposes, recording and monitoring of investment-related expenses, and preparation of all investment-related note disclosures for financial reporting purposes.

RECOMMENDATIONS

2006-1d Ensure adequate accounting resources exist to monitor control procedures and provide oversight of key accounting and financial reporting functions. Fill the vacant Assistant Director – Finance position.

2006-1e Consider redistributing or supplementing existing accounting resources to improve the coordination and performance of various investment-related accounting responsibilities.

*Auditee Views:*

*Through Fiscal 2006, the system employed an Assistant Director-Finance. Subsequent to her departure in June 2006, ERSRI engaged an independent CPA to assist with the fiscal 2006 audit and provide oversight of key accounting and financial reporting functions.*

*ERSRI concurs with recommendation 2006-1e.*

## FINDING 2006-2

**IMPLEMENT RECONCILIATION CONTROLS OVER THE ANCHOR AND GENERAL LEDGER ACCOUNTING SYSTEMS**

The ANCHOR system was designed to include a daily reconciliation function between data contained within the ANCHOR system and data contained within the PeopleSoft general ledger which is used for financial reporting purposes. The purpose of the reconciliation function is to ensure that the data contained within each system is fully synchronized. If variances do occur, the daily reconciliation process allows prompt investigation and correction. Although part of the system design, this function has never been fully operational.

Daily reconciliation between the Anchor and PeopleSoft components of the ERSRI accounting system is a critical control feature. Failure to perform this reconciliation is a weakness in control over financial reporting. Recently, ERSRI, working with its systems consultant, started to revisit this area of concern. During fiscal 2006, ERSRI began performing first level reconciliations between the ANCHOR system and its general ledger.

RECOMMENDATION

2006-2 Implement procedures to perform a daily automated reconciliation function between the ANCHOR and PeopleSoft components of the ERSRI accounting system.

*Auditee Views:*

*ERSRI anticipates implementation of a reconciliation procedure during Fiscal 2007.*

# OTHER FINDINGS AND RECOMMENDATIONS

## FINDING 2006-3

**PERFORM A RISK ANALYSIS / VULNERABILITY ASSESSMENT OF ERSRI's COMPUTER SYSTEMS**

ERSRI has made a substantial investment in its computer system and now nearly all operations are accomplished through, and dependent upon, the system. Security over the ERSRI computer system is an important concern because of the nature of the information and the long time horizon on which the information is collected and used.

Information technology security risk analysis, also known as risk / vulnerability assessment, is fundamental to the overall security of any organization using automated systems in support of its daily operations. Security controls are the management, operational and technical safeguards or countermeasures found within an information system designed to protect the confidentiality, integrity, and availability of the system and its information. Security controls designed for a specific system should be commensurate with the risks associated with that system.

A formal review should be performed to determine what IT security controls are required to adequately protect the information systems that support the day-to-day operations, and assets of the organization. This review would include these concerns:

- threats – all things that could go wrong or that can 'attack' the system. Threats would include all natural and man-made disasters, unauthorized use, fraud and abuse of the system and its data.
- vulnerabilities – these could allow a system to be more open to attack or make an attack more likely to succeed. There could exist both physical and logical vulnerabilities within any automated system.
- controls – these are specific countermeasures designed to mitigate vulnerabilities. Types of controls should include deterrent controls, preventative controls and corrective controls.

A risk/vulnerability assessment should be performed on a scheduled, recurring basis.

RECOMMENDATION

2006-3 Perform a risk analysis/vulnerability assessment of the ANCHOR system using appropriate methods and procedures to determine if controls have been implemented correctly, are operating as designed, producing the desired outputs, and meeting established security goals.

*Auditee Views:*

*ERSRI concurs with this recommendation. During fiscal 2006, ERSRI performed a preliminary review of potential consultants to assist with the risk analysis and vulnerability assessment and anticipates RFP issuance and contract award during fiscal 2007.*

## FINDING 2006-4

**DEVELOP INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES**

Appropriate oversight and management of an organization's information systems security program relies entirely upon the development and implementation of a formal comprehensive information security plan. The information systems security plan must consist of formally documented policies, procedures, standards, and current 'best practices' that are designed to safeguard the information contained within the various systems. The plan must be comprehensive in its coverage of all general IT security issues and reflect the security needs of the specific application systems.

While ERSRI has implemented procedures that address selected areas of information security, a comprehensive organization-wide information systems security plan designed to meet all of the security needs of its automated systems has not been developed or implemented. Senior management should be directly involved in developing an appropriate information systems security plan. This plan should include the following components:

- ***security policies* –** these should be comprehensive, concise, understandable, enforceable, and offer a balance between protection and systems productivity.

- ***security procedures* –** should detail how ERSRI would accomplish specific security control objectives considering existing security 'best practices'.

The policy along with all of its component sections must be periodically updated. At a minimum the information systems security plan should be reviewed on a scheduled basis or as required by major modifications in operations, computer hardware or software.

RECOMMENDATION

2006-4 Develop and implement comprehensive information systems security policies and procedures that will assure adequate security is provided for all ERSRI information collected, processed, transmitted, disseminated, or stored within in any of its automated applications.

*Auditee Views:*

*ERSRI concurs with this recommendation. Upon completion of the risk analysis and vulnerability assessment of the computer system in fiscal 2007, security policies and procedures will be developed.*

## FINDING 2006-5

**TIMELY IDENTIFICATION OF DECEASED RETIREES**

ERSRI can improve certain procedures to discontinue pension benefit payments to deceased retirees on a more timely basis thereby limiting overpayments requiring reimbursement. The risk of overpayments is increased by the fact that most pensions are paid through direct deposit into the retiree or beneficiary's bank account -- payments can be accepted without negotiation by the intended recipient.

ERSRI may be informed of a retiree or beneficiary's death through application for either beneficiary benefits or a death benefit payment. ERSRI also subscribes to a service which allows matching the retiree benefit payment file to a file containing information on deceased individuals. Other non-automated procedures are also performed to identify deceased retirees.

We matched ERSRI's benefit payment file for the first nine months of fiscal 2006 to a deceased individual database. The results of our testing indicated that the majority of pension benefit payments were discontinued within a reasonable time after the retiree or beneficiary's death. However, we did observe instances where controls within the ANCHOR system could be enhanced to reduce the opportunity for inappropriate payments upon death of the retiree or beneficiary.

Four cases that we reviewed indicate that ERSRI can improve controls to prevent pension benefit payments to deceased individuals. We found four pension payments that continued for six to seven months after death of the individual – after ERSRI had sufficient information available to discontinue the payments (e.g., it had received the death benefits application and other correspondence from the beneficiaries). In two instances, communication of the results of our testing caused suspension of the pension payment. In two cases, a death benefit was paid but the regular pension benefit payment continued.

We also noted instances where the full amount of the death benefit was paid without adjustment for overpayments caused by continuation of the monthly pension benefit after the retiree or beneficiary's death.

ERSRI may consider increasing the frequency of matching the pension benefit payment file to a database containing information on deceased individuals. This matching is currently performed quarterly. Increasing the frequency of the data matches may assist in the timely identification of deceased retirees or beneficiaries.

Death benefits should not be paid until a determination has been made that all overpayments have been collected or deducted from amounts due the beneficiary. ERSRI's ANCHOR system controls should be enhanced to prevent the processing of a death benefit without suspending the regular pension benefit payment.

RECOMMENDATIONS

2006-5a Consider increasing the frequency of matching ERSRI's pension benefit file to a database containing information on deceased individuals.

2006-5b Establish policies and procedures to withhold the payment of death benefits until all overpayments have been collected or deducted from amounts due the beneficiary.

2006-5c Utilize controls within the ANCHOR system to prevent payment of a death benefit without suspension of the regular pension benefit payment.

*Auditee Views:*

*ERSRI will examine the potential effectiveness of increasing the frequency of the subscription to the service, which allows matching the retiree benefit payment file to a database containing information on deceased individuals.*

*ERSRI will reinforce existing procedures and related ANCHOR systems to ensure more timely suspension of pension payments.*

*ERSRI will reinforce existing procedures related to ANCHOR functionality.*

The results of ERSRI's quarterly matches of pension benefit information to a deceased individual database, as well as our independent matching, identified some social security numbers as potentially invalid or questionable. In these instances, ERSRI should request validation of the social security number used by the retiree to rule out fraudulent activity and to ensure that tax withholdings and other deductions from the pension payment are being correctly applied.

RECOMMENDATION

2006-5d Request validation of social security numbers used by retirees and beneficiaries when data matches identify a social security number as being potentially invalid or questionable.

*Auditee Views:*

*ERSRI is dependent upon employers to provide accurate social security numbers (SSNs) for their employees. Although ERSRI believes fraudulent activity is negligible, upon application for pension benefits, ERSRI will request validation of SSN.*