
STATE OF RHODE ISLAND
EMPLOYEES' RETIREMENT SYSTEM
MANAGEMENT COMMENTS
JUNE 30, 1999 AUDIT

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

State of Rhode Island and Providence Plantations

GENERAL ASSEMBLY

Office of the Auditor General

1145 Main Street
Pawtucket, Rhode Island 02860-4807

OFFICE
(401) 222-2435
FAX
(401) 222-2111

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JOINT COMMITTEE ON LEGISLATIVE SERVICES:

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We audited the financial statements of the Employees' Retirement System of the State of Rhode Island (the System) for the year ended June 30, 1999 and have issued our report thereon dated February 1, 2000. In accordance with *Government Auditing Standards*, we have also issued a report dated February 1, 2000 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Our report on the System's compliance and internal control over financial reporting indicated no matters that we considered to be reportable conditions or material instances of noncompliance. However, during our audit, we noted certain matters involving compliance, internal controls, and other operational matters that are presented herein. These comments and recommendations are intended to enhance compliance with laws, regulations and contracts, improve internal control, or result in other operational efficiencies.

Sincerely,

Ernest A. Almonte, CPA, CFE
Auditor General

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EMPLOYEES' RETIREMENT SYSTEM INVESTMENTS

FAIR VALUE OF INVESTMENTS

Investment balances reported on the Employees' Retirement System (System) financial statements are derived from the custodian's records. Audit adjustments of \$14.9 million were required at June 30, 1999 to reflect certain of the System's investments (principally real estate and alternative investments) at fair value. These audit adjustments are required because the custodian does not receive the fourth quarter financial statements from the managers until after the fiscal year closes. The manager's financial statements include information which affects the fair value of these investments. Because of these timing differences, the investment balances, as reported by the custodian at June 30, will always require adjustment. The Treasurer's Office should calculate this net appreciation/depreciation in fair value of investments from the managers' quarterly financial statements so that the investment balances are reflected at fair value in the System's financial statements at June 30.

Similarly, the System's investment custodian recorded adjustments to cash, investments, and income after June 30, 1999 that related to June 30 and prior activity. As a result, audit adjustments of \$3.1 million were made to adjust the balances reported for investments and net appreciation in net assets in the financial statements. The Treasurer's Office should review the custodian's Cash Transaction Statement Reports and Base Equivalent Cash Statements of all managers for prior period adjustments that are made in the succeeding fiscal year so that the adjusted amounts, if material, will be reflected in the System's financial statements.

RECOMMENDATIONS

1. Calculate the net appreciation/depreciation in fair value of investments from quarterly manager's reports not booked by the custodian as of the fiscal year end.
2. Review the custodian's Cash Transaction Statement Reports and/or Base Equivalent Cash Statements for the first two months of the succeeding fiscal year to identify any material prior period adjustments that should be made to the financial statements.

Auditee Views

Treasury concurs with these recommendations.

INCOME AND RETURN OF CAPITAL TRANSACTIONS

As we reported in prior years, the State's investment custodian did not properly classify certain cash distributions from the real estate and alternative investment managers. Both the Treasurer's Office and the custodian receive letters and quarterly reports from the managers to identify distributions as either income or return of capital. In some instances, the custodian recorded returns of capital as

income and vice versa. If the Treasurer's Office reconciled the managers' quarterly reports to the custodian's reports, they would be able to identify these discrepancies.

RECOMMENDATION

3. Reconcile, on a quarterly basis, the investment managers' quarterly reports to the custodian's report to verify that investment transactions are properly reported.

Auditee Views

Treasury concurs with this recommendation.

RECONCILIATION OF TRANSFERS TO/FROM INVESTMENT CUSTODIAN

The transfer of funds to and from the State's investment custodian are reported in both the state accounting system and the custodian's records; however, the Treasurer's Office does not reconcile the two records. Monthly reconciliations by the Treasurer's Office would provide assurance that transfers were recorded properly. Transfers affect the ratios used to allocate pooled assets, liabilities, revenue, and expenditures among the four retirement plans. In June 1999, \$200,000 was transferred from the Short-term Investment Fund (i.e., Cash Account outside the Pooled Trust) to the Pooled Trust. Only the State and Municipal plans participated in the Short-term Investment Fund, but the funds were transferred to all four plans participating in the Pooled Trust. As a result, the Municipal, Judicial, and State Police plans received more funds and the State plan received fewer funds than what was originally attributed to them. In addition, we reported in prior years that the custodian had posted certain transfers between the State and the custodian to the wrong pension plans. To ensure that the custodian posts all transfers to the appropriate pension plans, the Treasurer's Office should reconcile the state's accounting system to the custodian's records of transfers and research any discrepancies.

RECOMMENDATION

4. Reconcile transfers to and from the State's investment custodian on a monthly basis.

Auditee Views

Treasury concurs with this recommendation.

EMPLOYEES' RETIREMENT SYSTEM ADMINISTRATION

PENSION BENEFIT INFORMATION SERVICE

The Retirement System provides a tape file of pensioners' social security numbers to the Pension Benefit Information (PBI) service, which then matches the social security numbers to its own database. PBI notifies Retirement of any social security numbers that are invalid or belong to deceased individuals. Once Retirement receives the report from PBI, they research whether those individuals are deceased. In four cases, Retirement confirmed that the pensioners were not deceased by contacting the pensioner via telephone and asking a series of questions.

One purpose of the PBI report is to determine if an individual may be fraudulently collecting a deceased person's pension -- verbal confirmation from a telephone call would not necessarily provide the proof that a pensioner is not deceased. Retirement should reevaluate its method of confirming the PBI report information.

RECOMMENDATION

5. Obtain definitive proof on whether a pensioner is deceased if his/her name appears on the PBI report.

Auditee Views

Retirement is investigating additional measures that can be taken to strengthen its process. Additionally, Retirement will develop a fact sheet in the member's folder detailing all actions taken.

DISTRESSED COMMUNITIES – INTEREST ON DEFERRED CONTRIBUTIONS

Three municipalities were allowed to defer the employers' share of retirement contributions for school department personnel in fiscal 1992 as provided by the Public Laws of 1993, Chapter 138 because these municipalities were determined to be distressed communities. Additionally, one municipality also deferred its share of contributions to the Teachers' Survivor Benefits (TSB) fund and the federally funded share for teachers' retirement. The deferred amount plus interest, as determined through an actuarial study, would be equally divided between 1994 and 2003 and paid directly by the State Department of Elementary and Secondary Education from school operations aid. The actuary calculated the interest payments using simple interest at 8 percent.

One municipality repaid its total deferral of \$932,587.33 on July 22, 1993. Another municipality repaid its deferral of \$127,730.61 for TSB and federally funded contributions by May 18, 1995. As we reported in prior years, neither community paid any interest on the deferred amounts. The Retirement Office should collect the interest due or request the Board to waive the accrued interest.

RECOMMENDATION

6. Inquire of the Retirement Board whether the interest due should be collected or waived.

Auditee Views

Retirement concurs with this recommendation.

AUTOMATED SYSTEMS

The Retirement Office is in the process of installing a new automated accounting and benefit system. This new system will not be fully operational for some time. With the implementation of this new system, some of the following findings on reconciliations, and pension payroll may be resolved; however, until then, the following issues require attention:

Reconciliations

The Retirement Office and the Office of Accounts and Control both record contributions, service credit purchases, transfers, and refunds in their respective accounting systems. As we reported in prior years, Retirement does not reconcile the balances in their accounting system to those in the State accounting system although the State accounting system is used to prepare Retirement's financial statements. Without the reconciliation process, differences between the two systems, such as the instances described below, will not be detected:

- A municipal police and fire department joined the Municipal Employees' Retirement System in fiscal 1998. Initial contributions of \$970,169 for prior service costs were received in October 1998 (fiscal 1999). These contributions were posted to the State's Accounting System as employer contributions in October 1998 when the funds were received but should have been recorded as member contributions. The contributions were credited to each employee's account in the Retirement Contribution System in June 1998 (fiscal 1998) prior to actually receiving the contributions.
- Employee contributions from the December 1998 payroll of one municipality were posted twice to each employee's contribution balance in the Retirement System. If an employee had withdrawn from the system, he/she would have been refunded more contributions than were actually contributed.
- The contributions from police and fire employees of one municipality were transferred from its municipal plan to its police and fire plan. The contributions of five employees were erroneously transferred twice to the new plan. Similarly, if one of these employees had withdrawn from the system, he/she would have been refunded more contributions than were actually contributed.

RECOMMENDATION

7. Reconcile Retirement's Contribution System balances to the State Accounting system balances monthly.

Auditee Views

Retirement concurs with this recommendation and has begun developing a new computer system which will address this concern.

Pension Payroll

As we reported in prior years, a data entry clerk in the Retirement Office enters the changes to the pension payroll and subsequently verifies the on-line screen to ensure that the changes were entered properly. The State's Office of Library and Information Services produces a detailed monthly report on the changes made. For control purposes, a second person should at least reconcile what the net change in gross pensions should be to the total changes posted.

In fiscal 1999, a pensioner erroneously received two pensions simultaneously. After receiving her first pension check, she requested a change in benefit option. The change in option was processed and a new pension benefit was calculated; however, the original pension was not terminated. The pensioner received two pension checks for fifteen months before Retirement realized the error. If Retirement were to generate a report on duplicate social security numbers (excluding the accounts for beneficiaries collecting), they could identify this type of error when it first occurs. In addition, this error could also have been detected if an independent person compared what should have been posted to the pension payroll to what was actually posted.

RECOMMENDATIONS

8. Require someone independent of the person entering data to the Retirement system to reconcile the net change in gross pensions to the total changes posted.
9. Generate a report on duplicate social security numbers appearing on the pension payroll, excluding the accounts for beneficiaries collecting, to investigate any duplicate pension checks.

Auditee Views

Retirement concurs with these recommendations and has assigned an individual to reconcile the net change in gross pensions each month and will develop procedures regarding recommendation 9.

CLARIFICATION OF RHODE ISLAND GENERAL LAWS

Some of the laws pertaining to the Employees' Retirement System need modification and/or clarification to meet the current needs of the System. The following are examples of certain sections of the laws that may require modification.

a) In prior years, we identified a State employee who had obtained a one-year vocational education teacher's certification that enabled him to purchase five years of service to apply towards retirement. Although the certificate allowed this individual to teach, this person was not employed as a teacher. This individual was a State employee for about 20 years with the Department of Education. To qualify for this certificate, one must satisfy the following requirements:

- have a high school diploma,
- take a written and practical examination administered by the Department of Education (may be waived),
- complete twelve semester hours of professional education courses (six credits must be in vocational education methods and curriculum), and
- work at least five years in the field that one will teach.

Section 16-16-6.2 of the RI General Laws allows vocational education teachers, who are employed by the State or a municipality, to purchase up to five years of service to apply towards retirement, for the length of time they spent working in the field that they are currently teaching. It is not clear whether a vocational education teacher is someone who actually teaches vocational courses to students in a classroom or anyone in possession of a vocational education certificate with appropriate work experience and whose job title falls under the broad definition of "teacher". Other state employees may also fall within this broad definition of teacher; thereby qualifying for this service credit purchase.

b) Sections 8-3-16, 8-8-10.1, 28-30-8.1, and 31-43-11.1 of the RI General Laws establish restricted receipt accounts to hold in trust the retirement contributions of judges appointed after December 31, 1989. Likewise, Section 42-28-22.1 of the RI General Laws establishes a restricted receipt account to hold in trust the retirement contributions of the state police hired after July 1, 1987. There are two plans in effect for both state police and judges. State police and judges hired/appointed prior to the above dates do not contribute to the retirement plans and their pensions are paid directly from state appropriations. In contrast, the state police and judges hired/appointed after those dates contribute to the plan and their pensions will be paid from the contributed funds. There is a question on who actually administers the pension plans for the state police and judges hired after those dates. The laws empower the Retirement Board to establish rules and regulations to govern the plan; however, it is not clear if the Board administers only the contributions and the investment of those contributions. The laws do not refer to the Retirement Board when discussing the administration of pension benefits. These laws should be clarified to specifically identify who administers the above mentioned plans.

c) Section 36-8-10.1 of the RI General Laws establishes a restricted receipt account within the State's General Fund to pay the expenses of the Retirement Board and the cost of maintaining and administering the retirement system. Sections 36-8-10.1 and 45-21-42.1 of the RI General

Laws authorize transfers of up to 1.5% of the investment income received by the Employees' Retirement System and the Municipal Employees' Retirement System, respectively, to the restricted receipt account. The amount of the transfer is limited by reference to investment income as reported in the annual report of the audited financial statements of the plans or system. Due to a change in accounting principles, the change in fair value of investments is now included as a component of net investment income. One and one-half percent of the total net investment income including change in the fair value is a significantly higher number than what was previously considered as a cap. The law requires some modifications because of this change in accounting principles.

- d) We reported in prior years that administrative expenses incurred by both the Retirement Board and Office were charged to the State Police and Judicial retirement plans although there is no statutory authority or agreement to allow this. Although the administrative expenditures charged to the two plans are not material, the RI General Laws should be modified to address administrative transfers from the State Police and Judicial retirement plans.
- e) As we reported in prior years, Retirement's procedures are not adequate to determine the income earned by those pensioners collecting a disability pension. Retirement obtains a listing of state withholding amounts from the R.I. Division of Taxation, but the amount of tax withheld is not an accurate reflection of income earned. In addition, the report is not useful for tracking the income earned by out-of-state pensioners. Although the "Continuing Statement of Disability" form requires all self-employed disability beneficiaries to submit a copy of their federal tax return and all others to submit identification of their wages (W-2), this is not required by law. Unless all disabled pensioners submit copies of their federal tax form with their W-2 form(s), one cannot determine if all W-2's have been submitted. All wages, including out of state wages, should be verified to determine that total earnings, including both disability benefits and personal earnings, do not exceed the amount of compensation presently paid to an individual who holds the position from which the pensioner retired.
- f) Sections 36-10-17, 16-16-19, and 45-21-23 of the RI General Laws address reexamination of disability beneficiaries and reinstatement to active service. If a reexamination determines that a beneficiary is able to engage in a gainful occupation, his name is to be placed on the appropriate lists of candidates for appointment to positions in his department or agency for which he is stated to be qualified. If the beneficiary finds employment, the Retirement Board shall adjust the amount of his or her disability benefit so that the total of his pension and earnings do not exceed the annual compensation currently in effect for the classification that the disability annuitant held prior to retirement. Some employers have refused to rehire former employees unless so ordered by the courts. If the beneficiary is not rehired, although fit for work, Retirement continues to pay his benefits. In one situation, a recipient was found fit to return to work in fiscal 1995, but the town would not rehire the individual. Consequently, the recipient is still collecting a disability pension in fiscal 1999. The general laws do not address payment of disability benefits when an employer refuses to rehire a beneficiary that is able to return to work.

- g) We also noted situations in which the disability recipients were employed, but the earnings combined with the disability pensions were less than what they would have made if still employed in their former positions. For example, a teacher retired with a disability pension but he is currently employed as a program planner in another school department. Although the individual earns less than what he would have earned in his former position, one questions whether the intent of the law is to pay a disability pension to an individual who is not totally disabled, but can be gainfully employed. The general laws do not specifically address these situations.

RECOMMENDATION

10. Review various sections of the RI General Laws affecting the administration of the Retirement System and request the General Assembly to make necessary amendments.

Auditee Views

Retirement concurs with this recommendation and will provide these issues to the board's Legislative subcommittee for review.