
**STATE OF RHODE ISLAND
EMPLOYEES' RETIREMENT SYSTEM
FISCAL YEAR ENDED JUNE 30, 2004**

Ernest A. Almonte, CPA, CFE
Auditor General

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



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STATE OF RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

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June 30, 2005

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, 2004 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, CPA, CFE
Auditor General

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
FISCAL YEAR ENDED JUNE 30, 2004

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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, 2004 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, 2004, 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, 2004, 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 May 20, 2005 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 25 and 26 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, CPA, CFE
Auditor General

May 20, 2005

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

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, 2004. 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 are each separate plans. The *Statements of Fiduciary Net Assets* provide a snapshot of the financial position of the System at June 30, 2004. 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, 2004

- £ The System's fiduciary net assets increased by \$819.6 million from \$5.4 billion at June 30, 2003 to \$6.3 billion at June 30, 2004.
- £ Total pension benefits paid to members were \$519.6 million, an increase of \$49.4 million or 10.5% compared to the fiscal year ended June 30, 2003.
- £ Total employee and employer contributions into the System's plans increased \$42 million compared to the prior year. Total contributions from both employers and employees were \$342.3 million.
- £ The System incurred a net gain from investing activities of \$1.0 billion for the fiscal year ended June 30, 2004. Included in this amount is \$1.6 million in securities lending income.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Management's Discussion and Analysis

Assets, Liabilities and Fiduciary Net Assets		
(in millions)		
	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Assets:		
Cash and cash equivalents	\$ 9.5	\$ 3.4
Investments	6,193.8	5,386.7
Contributions receivable	49.7	39.3
Due from other plans	24.8	14.7
Invested securities lending collateral	806.5	582.4
Property and equipment	<u>14.5</u>	<u>15.4</u>
Total assets	7,098.8	6,041.9
Liabilities:		
Accounts payable	7.6	4.5
Due to other plans	24.8	14.7
Securities lending liability	<u>806.5</u>	<u>582.4</u>
Total liabilities	838.9	601.6
Net assets:	<u>\$ 6,259.9</u>	<u>\$ 5,440.3</u>

Summary of Changes in Fiduciary Net Assets		
(in millions)		
	<u>Year Ended</u>	<u>Year Ended</u>
	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Additions:		
Contributions	\$ 342.3	\$ 300.5
Net investment gain (loss)	<u>1,010.2</u>	<u>147.2</u>
Total Additions	1,352.5	447.7
Deductions:		
Benefits	519.5	470.1
Refunds of contributions	7.9	6.6
Administrative expenses	<u>5.5</u>	<u>5.0</u>
Total Deductions	532.9	481.7
Increase (Decrease) in Fiduciary Net		
Assets:	\$ 819.6	\$ (34.0)
Net Assets:		
Beginning of year	<u>5,440.3</u>	<u>5,474.3</u>
End of year	<u>\$ 6,259.9</u>	<u>\$ 5,440.3</u>

Management's Discussion and Analysis

Investments

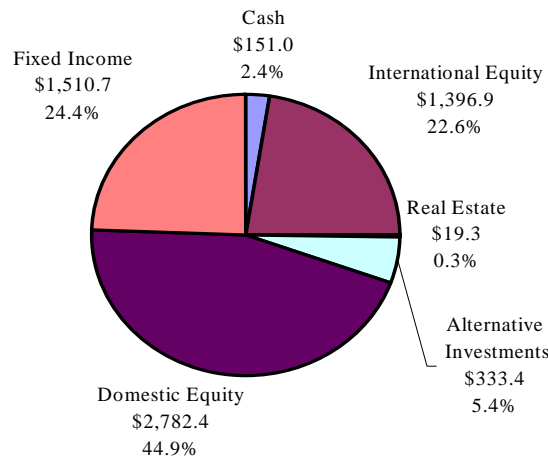
The State Investment Commission (SIC) establishes long-term asset allocation policy and monitors investment performance of the plan. An asset/liability (A/L) study is conducted every two to three years to identify an optimal diversified investment portfolio that maximizes return within an acceptable 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, 2004.

Fiscal 2004 – Asset Allocation Targets	
Domestic Equity	42.5%
International Equity	20.0%
Fixed Income	25.0%
Alternative Investments	7.5%
Real Estate (1)	5.0%

(1) The real estate allocation was established in January 2003. The majority of this allocation was invested at June 30, 2004 in the domestic and international equity portfolios, which will fund approved real estate investments over time.

Asset Allocation - Actual
Fair value (in millions) at June 30, 2004



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

Management's Discussion and Analysis

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, 2004 were 19.5%, 4.4% and 2.0%, respectively.

The equity markets worldwide continued their rally during fiscal year 2004. The United States equity markets, as measured by the Wilshire 5000 Index, returned 21.2% for the year. Internationally, markets were up 32.4%, as measured by the Morgan Stanley Capital Investment all Country World Index (MSCI ACWI) excluding the United States. Markets were driven by a global acceleration in growth, investor confidence and historically low interest rates. The Federal Reserve's one quarter of a percent rate hike on June 30th ended a four-year period of decreases that included thirteen rate cuts. While terrorism fears and uncertainty surrounding the war in Iraq and geopolitical uncertainty remained on the front pages, investors saw a global recovery and the high growth rates in corporate profits as compelling reason to purchase equities. As the US recovery became more evident near the end of the year and the debate over a jobless recovery quieted, interest rates rose and resulted in a nearly flat year for the bond market, which returned 0.3% as measured by the Lehman Aggregate Index.

For the fiscal year ended June 30, 2004 the domestic equity portfolio was up 23.4% (vs. 19.1% for the S&P 500), the international portfolio posted a 26.5% return (vs. 32.4% for the MSCI ACWI ex US) and the fixed income composite returned 4.1% (vs. 0.3% for the Lehman Aggregate). The private equity portfolio realized a gain of 27.1% on a time-weighted total return basis for fiscal 2004 and the real estate portfolio has generated a 3.6% return. Since inception, the private equity composite has generated an internal rate of return of 13.4%.

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, 2003), the funded ratio decreased to 65.5% for State Employees and 64.9% for Teachers within the Employees Retirement System plan and decreased for the State Police to 73.7%. The Judges plan is the only plan that experienced an increase in the funding ratio to 72%. While the Municipal Employees Retirement System Plan's funded ratio declined, it remained over funded with an overall ratio of 100.7%. Details of the funded status of each plan within the System are included in the Schedules of Funding Progress on page 25.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Management's Discussion and Analysis

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, 2004 consistent with the overall performance of domestic and international equity markets.

Employer contribution rates for fiscal 2005 increased for State employees (9.60% for fiscal 2004 compared to 11.51% for fiscal 2005), teachers (13.72% for fiscal 2004 compared to 14.84% for fiscal 2005), state police (26.77% for fiscal 2004 compared to 28.87% for fiscal 2005), and judges (33.90% for fiscal 2004 compared to 36.19% for fiscal 2005). The fiscal 2005 employer contribution rates are based upon an actuarial valuation performed at June 30, 2002.

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 STATE OF RHODE ISLAND
Statements of Fiduciary Net Assets
As of June 30, 2004

	<u>ERS</u>	<u>MERS</u>	<u>SPRBT</u>	<u>JRBT</u>	Total Memorandum Only
Assets					
Cash and cash equivalents (Note 3)	\$ 8,558,698	\$ 546,815	\$ 218,178	\$ 170,589	\$ 9,494,280
Receivables					
Contributions	24,791,198	2,948,170	-	18,342	27,757,710
Due from State for teachers	18,428,459	-	-	-	18,428,459
Due from other plans	1,255,196	23,581,764	-	-	24,836,960
Other	3,483,015	-	-	44	3,483,059
Total receivables	<u>47,957,868</u>	<u>26,529,934</u>	<u>-</u>	<u>18,386</u>	<u>74,506,188</u>
Investments at fair value (Note 3)					
Equity in short-term investment fund	-	6,525,700	-	-	6,525,700
Equity in pooled trust	5,327,151,706	797,601,108	24,272,810	15,649,831	6,164,675,455
Plan specific investments	22,629,221	-	-	-	22,629,221
Total investments before lending activities	<u>5,349,780,927</u>	<u>804,126,808</u>	<u>24,272,810</u>	<u>15,649,831</u>	<u>6,193,830,376</u>
Invested securities lending collateral (Note 3)	<u>696,928,405</u>	<u>104,346,689</u>	<u>3,175,436</u>	<u>2,047,351</u>	<u>806,497,881</u>
Property and equipment at cost net of accumulated depreciation (Note 4)					
Line of business system (net of accumulated depreciation \$3,107,456)	12,488,237	1,838,681	31,065	19,998	14,377,981
Computer equipment (net of accumulated depreciation \$572,958)	142,688	20,859	299	193	164,039
Total property and equipment	<u>12,630,925</u>	<u>1,859,540</u>	<u>31,364</u>	<u>20,191</u>	<u>14,542,020</u>
Total Assets	<u>6,115,856,823</u>	<u>937,409,786</u>	<u>27,697,788</u>	<u>17,906,348</u>	<u>7,098,870,745</u>
Liabilities					
Securities lending liability (Note 3)	696,928,405	104,346,689	3,175,436	2,047,351	806,497,881
Accounts payable	6,443,172	1,158,605	26,362	14,784	7,642,923
Due to other plans	23,581,764	1,255,196	-	-	24,836,960
Total Liabilities	<u>726,953,341</u>	<u>106,760,490</u>	<u>3,201,798</u>	<u>2,062,135</u>	<u>838,977,764</u>
Net assets held in trust for pension benefits (A schedule of funding progress for each plan is presented on page 25.)	<u>\$ 5,388,903,482</u>	<u>\$ 830,649,296</u>	<u>\$ 24,495,990</u>	<u>\$ 15,844,213</u>	<u>\$ 6,259,892,981</u>

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, 2004

	ERS	MERS	SPRBT	JRBT	Total Memorandum Only
Additions					
Contributions					
Member contributions	\$ 134,023,197	\$ 19,554,401	\$ 727,018	\$ 472,389	\$ 154,777,005
Employer contributions	128,029,551	9,406,148	2,224,191	1,830,205	141,490,095
State contribution for teachers	45,039,278	-	-	-	45,039,278
Interest on service credits purchased	897,836	89,185	-	-	987,021
Total contributions	307,989,862	29,049,734	2,951,209	2,302,594	342,293,399
Investment income					
Net appreciation in fair value of investments	740,815,130	111,277,572	2,973,585	1,904,546	856,970,833
Interest	62,532,932	14,546,701	275,297	175,633	77,530,563
Dividends	35,053,694	5,240,647	148,104	94,507	40,536,952
Other investment income	41,226,400	6,166,358	178,383	114,222	47,685,363
	879,628,156	137,231,278	3,575,369	2,288,908	1,022,723,711
Less investment expense	(12,224,707)	(1,827,023)	(53,194)	(33,989)	(14,138,913)
Net investment income	867,403,449	135,404,255	3,522,175	2,254,919	1,008,584,798
Securities lending					
Securities lending income	5,605,171	839,227	25,538	16,466	6,486,402
Less securities lending expense	(4,203,642)	(629,385)	(19,153)	(12,349)	(4,864,529)
Net securities lending income	1,401,529	209,842	6,385	4,117	1,621,873
Total net investment income	868,804,978	135,614,097	3,528,560	2,259,036	1,010,206,671
Miscellaneous revenue					
	27,329	2,214	-	-	29,543
Total Additions	1,176,822,169	164,666,045	6,479,769	4,561,630	1,352,529,613
Deductions					
Benefits					
Retirement benefits	357,334,428	34,042,081	69,279	145,209	391,590,997
Cost of living adjustments	92,141,222	4,521,232	750	4,146	96,667,350
SRA Plus Option	25,335,942	1,194,594	-	-	26,530,536
Supplemental benefits	1,035,359	325	-	-	1,035,684
Death benefits	3,164,600	595,600	-	-	3,760,200
Total benefits	479,011,551	40,353,832	70,029	149,355	519,584,767
Refund of contributions	6,421,543	1,418,758	10,895	-	7,851,196
Administrative expense	4,738,363	712,833	15,123	9,525	5,475,844
Total Deductions	490,171,457	42,485,423	96,047	158,880	532,911,807
Net Increase	686,650,712	122,180,622	6,383,722	4,402,750	819,617,806
Net assets held in trust for pension benefits					
Beginning of year	4,702,252,770	708,468,674	18,112,268	11,441,463	5,440,275,175
End of year	\$ 5,388,903,482	\$ 830,649,296	\$ 24,495,990	\$ 15,844,213	\$ 6,259,892,981

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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

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:

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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

1. Plan Descriptions (continued)

(a). General

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, 2003 actuarial valuation is listed below:

	<i>Retirees and beneficiaries</i>	<i>Terminated plan members entitled to but not yet receiving benefits</i>	<i>Active Vested</i>	<i>Active Non- vested</i>	<i>Total by Plan</i>
<u>ERS</u>					
State Employees	9,398	1,876	8,925	4,356	24,555
Teachers	7,704	1,404	7,387	7,023	23,518
<u>MERS</u>					
General Employees	3,343	1,258	2,821	4,060	11,482
Public Safety	328	39	580	585	1,532
<u>SPRBT</u>	1	-	-	150	151
<u>JRBT</u>	2	-	2	40	44
<i>Total by type</i>	20,776	4,577	19,715	16,214	61,282

(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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

1. Plan Descriptions (continued)

(b). Membership and Benefit Provisions

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 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.

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.

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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Financial Statements

Fiscal Year Ended June 30, 2004

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.

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:

<u>Highest Annual Salary</u>	<u>Spousal Monthly Minimum Benefit</u>
\$17,000 or less	\$600
\$17,001 to \$25,000	\$700
\$25,001 to \$33,000	\$800
\$33,001 to \$40,000	\$900
\$40,001 and over	\$1,000

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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Financial Statements

Fiscal Year Ended June 30, 2004

1. Plan Descriptions (continued)

(b). Membership and Benefit Provisions

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). 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	66
Municipal police and fire departments	<u>44</u>
Total participating units as of the actuarial valuation at June 30, 2003	<u>110</u>

(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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Financial Statements

Fiscal Year Ended June 30, 2004

1. Plan Descriptions (continued)

(b). Membership and Benefit Provisions

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

(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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

2. Summary of Significant Accounting Policies (continued)

are recognized in the period in which the contributions are due. 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. 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 are 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 valued based on audited December 31 net asset values adjusted for purchases, sales, and cash flows for the period January 1 to June 30.

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, plant and equipment is allocated to each plan based on its proportionate share of net assets.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

2. Summary of Significant Accounting Policies (continued)

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

(a). Cash Deposits and Cash Equivalents

At June 30, 2004, the carrying amounts of the plans' cash deposits are listed below:

	<u>ERS</u>	<u>MERS</u>	<u>SPRBT</u>	<u>JRBT</u>
<i>Book balance</i>	\$ 8,523,806	\$ (44,141)	\$ 0	\$ 0
<i>Bank balance</i>	\$ 8,423,115	\$ 1,030,617	\$ 0	\$ 0

The bank balances represent the plans' deposits in short-term trust accounts that are covered by federal depository insurance. The book and bank balances include fully collateralized deposits of \$6,015,088 in ERS, and \$406 in MERS and a certificate of deposit of \$1 million in MERS with a maturity of less than sixty days. At the end of each business day, the excess bank balances are invested in overnight repurchase agreements, which are categorized in the following table as category 1 investments (see Note 3(b) Investments).

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, 2004.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

3. Cash Deposits and Investments (continued)

(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). As of June 30, 2004, the ERS held a loan receivable with a fair value of \$22,129,221. This loan is secured by commercial real estate located in Rhode Island.

The System's investments (at fair value) are categorized in the following table to give an indication of the level of risk assumed by the entity at June 30, 2004:

Category 1 includes insured or registered, or securities held by the System or its agent in the System's name.

Category 2 includes uninsured and unregistered, with securities held by the counterparty's trust department or agent in the System's name.

Category 3 includes uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the System's name.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

3. Cash Deposits and Investments (continued)

(b). Investments

<u>Investments - Category 1</u>	<u>Short-term Investment Fund</u>	<u>Pooled Trust</u>	<u>Plan Specific</u>
US Government and Agency Securities			
Not on securities loan		\$ 498,995,409	
On loan for securities collateral		3,744,892	
Domestic Corporate Bonds and Notes		519,855,216	\$ 22,129,221
Foreign Bonds		33,465,959	
Domestic Equity Securities			
Not on securities loan		915,166,182	
On loan for securities collateral		1,288,314	
Foreign Equity Securities			
Not on securities loan		719,420,481	
On loan for securities collateral		4,268,315	
Repurchase Agreements		1,014,614	
Subtotal	-	2,697,219,382	22,129,221
 <u>Items not categorized</u>			
Commingled funds		2,208,899,258	
Real Estate and Alternative Investment Partnerships		352,759,187	
Money Market Mutual Funds	\$ 6,503,681	136,536,149	500,000
Investments held by broker-dealers under securities loans with cash collateral			
US Government and Agency Securities		379,417,784	
Domestic Corporate Bonds and Notes		52,536,610	
Domestic Equity Securities		213,716,595	
Foreign Equity Securities		143,732,595	
Securities lending short-term collateral investment pool		806,497,881	
Subtotal	6,503,681	4,294,096,059	500,000
Total	6,503,681	6,991,315,441	22,629,221
 <u>Reconciliation to Statements of Fiduciary Net Assets</u>			
Total above	6,503,681	6,991,315,441	22,629,221
Net investment payable/receivable	22,019	(27,103,235)	
Foreign cash *		3,870,126	
Domestic cash *		4,105,618	
Securities Lending short-term collateral investment pool		(806,497,881)	
Cash equivalents		(1,014,614)	
Investments on Statements of Fiduciary Net Assets	\$ 6,525,700	\$ 6,164,675,455	\$ 22,629,221

* Foreign cash deposits at the System's custodian bank are uncollateralized and are not covered by United States federal depository insurance. Domestic cash deposits are fully insured by the Federal Deposit Insurance Corporation.

3. Cash Deposits and Investments (continued)

(c). 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, futures contracts and mortgage-backed securities. 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 may enter 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 Plan 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 may use 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.

Mortgage-Backed Securities – 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 aggregate as U.S. Government and Agency Securities in the disclosure of custodial credit risk. 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

3. Cash Deposits and Investments (continued)

(c). Derivatives and Other Similar Investments

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.

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 total return swaps.

The commingled funds 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 commingled fund when the price of a security underlying the short sale increases and the commingled fund is subject to a higher cost to purchase the security in order to cover the position.

(d). Securities Lending

Policies of the State Investment Commission permit use of investments 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. There are no restrictions on the amount of loans that can be made. Securities on loan at year-end for cash collateral are presented as not categorized in the preceding table. Securities on loan for noncash collateral are classified according to the category for the collateral. 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 for an average duration of 52 days and a weighted average maturity of 118 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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Financial Statements
Fiscal Year Ended June 30, 2004

3. Cash Deposits and Investments (continued)

(d). Securities Lending

no losses during the fiscal year resulting from default of the borrowers or lending agent.

At June 30, 2004, 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 \$798,705,105 (fair value), and the collateral received for those securities on loan was \$816,221,400 (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, 2004 were:

	ERS	MERS	SPRBT	JRBT	Total
Line of Business System	\$15,189,553	\$2,234,792	\$ 37,161	\$ 23,929	\$17,485,435
Accumulated Depreciation	2,701,317	396,112	6,097	3,931	3,107,457
Net Line of Business System	<u>\$12,488,236</u>	<u>\$1,838,680</u>	<u>\$ 31,064</u>	<u>\$ 19,998</u>	<u>\$14,377,978</u>
Equipment	\$ 641,267	\$ 93,634	\$ 1,271	\$ 824	\$ 736,996
Accumulated Depreciation	498,580	72,776	972	630	572,958
Net Equipment	<u>\$ 142,687</u>	<u>\$ 20,858</u>	<u>\$ 299</u>	<u>\$ 194</u>	<u>\$ 164,038</u>

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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Financial Statements

Fiscal Year Ended June 30, 2004

5. Contributions (continued)

(a). Funding Policy

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.

(b). Contributions

Employer contribution rates for fiscal 2004 were developed based on an actuarial valuation performed as of June 30, 2001. The table below displays the contribution rates for the year ending June 30, 2004:

Plan	Employee	Employer
ERS		
State Employees	8.75%	9.60%
Teachers	9.50%	7.99% (7.15% for towns not participating in the 1990 early retirement incentive)
<i>Municipal funded</i>		
<i>State funded</i>		5.73% (5.16% for towns not participating in the 1990 early retirement incentive)
MERS		
General Employees	6.00% (additional 1% with a cost-of-living adjustment)	66 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	44 Municipal police and fire departments contributed various actuarially determined rates.
SPRBT	8.75%	26.77%
JRBT	8.75%	33.90%

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Financial Statements

Fiscal Year Ended June 30, 2004

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 general fund.

8. Subsequent Events

In December 2004, the obligor of a mortgage loan receivable (outstanding balance of approximately \$22 million as of December 1, 2004) held by the System as a plan specific investment defaulted on its obligation. The System has a first lien on commercial real estate located in Providence, Rhode Island with a court approved appraised value of \$18.6 million. The mortgage loan receivable is guaranteed by the Rhode Island Economic Development Corporation to the extent of \$3 million. The System is pursuing its rights through the U.S. Bankruptcy Court. Management cannot estimate the likelihood or amount of loss, if any, that the plan may incur.

Employees' Retirement System of the State of Rhode Island

Required Supplementary Information

EMPLOYEES' RETIREMENT SYSTEM OF RHODE ISLAND

REQUIRED SUPPLEMENTARY INFORMATION

Schedules Of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	**	***	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
		Actuarial Accrued Liability (AAL) - Entry Age - (b)	Unfunded AAL (UAAL) (b - a)			
ERS (State Employees)						
6/30/2003	\$ 2,267,673,016	\$ 3,461,708,161	\$ 1,194,035,145	65.5%	606,102,182	197.0%
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%
6/30/1999 *	2,201,890,748	2,607,397,329	405,506,581	84.4%	494,815,513	82.0%
6/30/1998	2,075,619,320	2,576,282,134	500,662,814	80.6%	477,319,627	104.9%
6/30/1997	1,810,447,649	2,312,563,765	502,116,116	78.3%	443,709,290	113.2%
ERS (Teachers)						
6/30/2003	\$ 3,427,685,554	\$ 5,284,933,149	\$ 1,857,247,595	64.9%	\$ 834,642,391	222.5%
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%
6/30/1999 *	3,259,015,814	3,967,529,172	708,513,358	82.1%	673,484,467	105.2%
6/30/1998	3,045,858,851	3,999,722,806	953,863,955	76.2%	636,246,593	149.9%
6/30/1997	2,626,621,502	3,579,652,537	953,031,035	73.4%	604,076,573	157.8%
SPRBT						
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%
6/30/1999 *	8,480,657	10,841,544	2,360,887	78.2%	7,502,433	31.5%
6/30/1998	6,756,892	7,338,161	581,269	92.1%	7,211,874	8.1%
6/30/1997	4,861,569	5,435,913	574,344	89.4%	5,370,985	10.7%
JRBT						
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%
6/30/1999 *	5,521,693	7,415,237	1,893,544	74.5%	3,169,183	59.7%
6/30/1998	4,120,032	5,048,855	928,823	81.6%	3,039,957	30.6%
6/30/1997	2,607,482	3,508,327	900,845	74.3%	2,815,218	32.0%
MERS						
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)%
6/30/1999	805,493,262	635,863,479	(169,629,783)	126.7%	191,234,546	(88.7)%
6/30/1998	737,745,574	572,905,862	(164,839,712)	128.8%	181,260,006	(90.9)%
6/30/1997	667,632,428	502,247,591	(165,384,837)	132.9%	167,527,881	(98.7)%

See notes to required supplementary information

* Restated numbers based on Entry Age Normal funding method

** Frozen Actuarial Liability for ERS, SPRBT, JRBT for plan years 1998 and prior

*** Unfunded Frozen Actuarial Liability for ERS, SPRBT, JRBT for plan years 1998 and prior

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	Annual Required	Percentage	Annual Required	Percentage	Annual Required	Percentage	
June 30	Contribution	Contributed	Contribution	Contributed	Contribution	Contributed	
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%	
2000	44,353,675	100%	40,719,407	100%	57,667,528	100%	
1999	48,526,064	100%	30,202,943	100%	42,373,952	100%	

MERS		
Fiscal		
Year Ended	Annual Required	Percentage
June 30	Contribution	Contributed
2004	9,406,147	100%
2003	6,485,065	100%
2002	7,536,081	100%
2001	6,092,688	100%
2000	5,823,861	100%
1999	6,608,642	100%

SPRBT		
Fiscal		
Year Ended	Annual Required	Percentage
June 30	Contribution	Contributed
2004	2,224,191	100%
2003	2,256,770	100%
2002	2,405,041	100%
2001	1,819,930	100%
2000	1,508,778	100%
1999	631,386	100%

JRBT		
Fiscal		
Year Ended	Annual Required	Percentage
June 30	Contribution	Contributed
2004	1,830,204	100%
2003	1,656,965	100%
2002	1,458,093	100%
2001	1,163,571	100%
2000	1,007,618	100%
1999	737,414	100%

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
Notes to Required Supplementary Information
Fiscal Year Ended June 30, 2004

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.

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.

Effective with the June 30, 1999 valuation, which was restated, certain actuarial assumptions were changed. Specifically, the actuarial cost method for ERS, SPRBT and JRBT were set to Entry Age Normal and the amortization period was changed to 30 years. The inflation assumption was decreased from 3.5% to 3.0%.

Effective with the June 30, 1999 valuation, the actuarial value of assets was developed using a five-year smoothed market technique for ERS, SPRBT and JRBT.

Effective with the June 30, 1998 valuation, the actuarial value of assets was developed using a four-year moving average technique for ERS, SPRBT and JRBT. The MERS actuarial value of assets was developed using a three-year smoothing of the market value of assets.

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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Notes to Required Supplementary Information

Fiscal Year Ended June 30, 2004

2. Schedules of Employer Contributions (continued)

The Plans used 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				
	<i>State Employees</i>	<i>Teachers</i>	MERS	SPRBT	JRBT
Valuation Date	6/30/03	6/30/03	6/30/03	6/30/03	6/30/03
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	26 years	26 years	26 Years	26 years	26 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%	<u>General Employees</u> 4.50% to 9.00% <u>Police & Fire Employees</u> 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	3.0% compounded	3.0% compounded	3.0% Non-compounded	\$1,500 per annum	3.0% (see Note 1(b)(4)) to the financial statements



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STATE OF RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

- ◆ 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, 2004 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated May 20, 2005. 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 record, process, summarize, 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 2004-1, 2004-2, 2004-3, and 2004-4.

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 2004-1, 2004-2, 2004-3, and 2004-4 to be material weaknesses.

Compliance and Other Matters

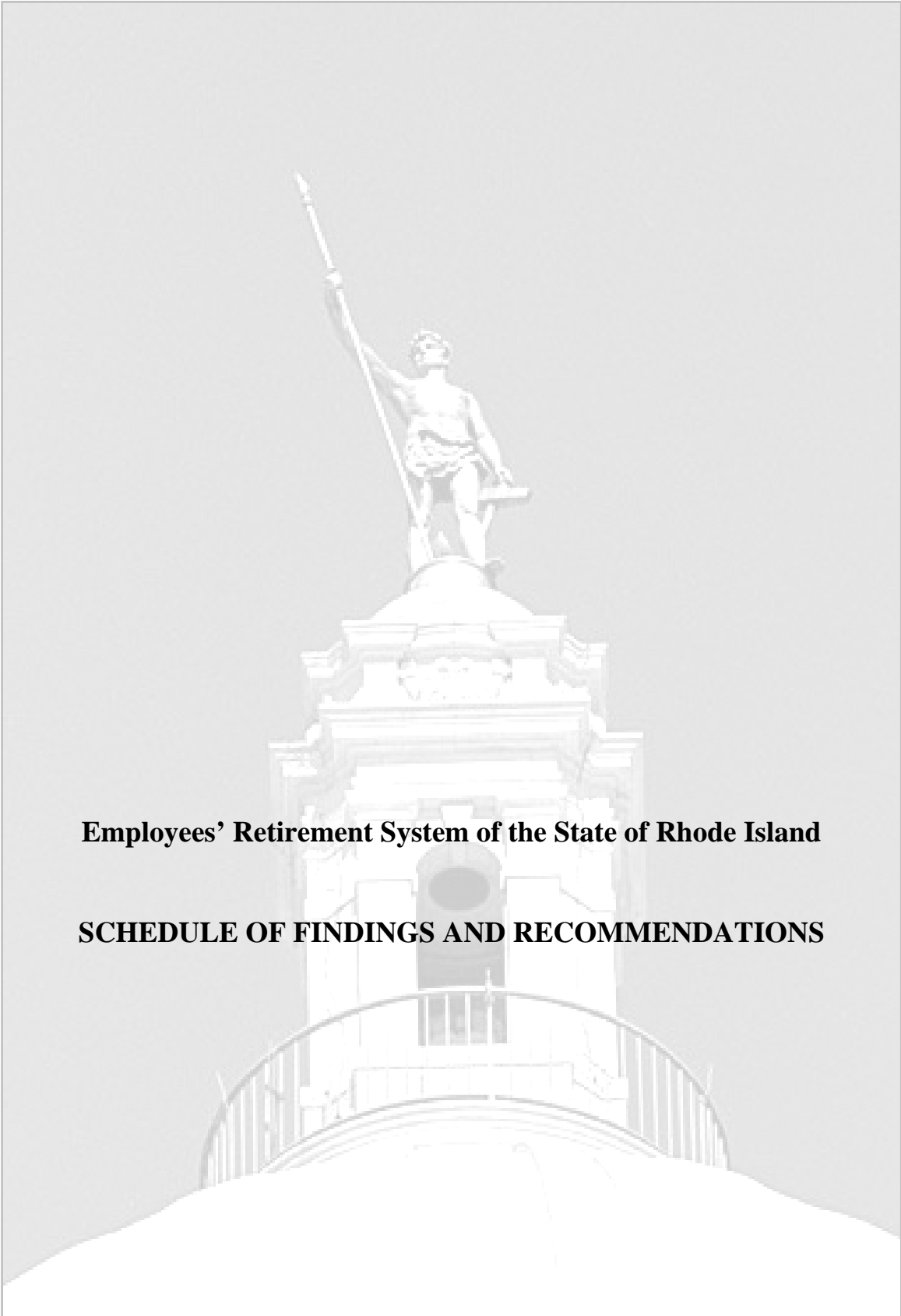
As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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, CPA, CFE
Auditor General

May 20, 2005



Employees' Retirement System of the State of Rhode Island

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

**Employees' Retirement System of the State of Rhode Island
Schedule of Findings and Recommendations**

REPORTABLE CONDITIONS

FINDING 2004-1

PREPARE TIMELY BANK RECONCILIATIONS

Monthly bank reconciliations were not performed timely for the Employees' Retirement System of the State of Rhode Island (ERSRI) bank accounts during fiscal 2004. June 30, 2004 balances were not completely reconciled until April 2005. Timely bank reconciliations are an integral component of internal control over the recording of receipts and disbursements. Consequently, controls over receipts and disbursements were severely weakened during fiscal 2004.

Individuals performing the reconciliation of the ERSRI bank accounts need access to, and be trained in using, the ERSRI general ledger accounting system. Additionally, various issues relating to how receipts are batched for deposit and entered into the accounting system need to be addressed to facilitate timely bank reconciliations.

RECOMMENDATIONS

1. Reconcile all ERSRI bank accounts to the general ledger on a timely basis.
2. Grant appropriate access to the ERSRI accounting system for staff performing monthly bank reconciliations and train staff to use the accounting system.
3. Re-examine the processes used to batch and record cash receipts to facilitate timely bank reconciliations.

Auditee Views:

ERSRI concurs with these recommendations.

FINDING 2004-2

IMPROVE CONTROLS OVER FINANCIAL REPORTING

ERSRI's process for preparing financial statements is deficient. Information needed to prepare financial statements is not readily available and, in some cases, requires extensive analysis and correction. Personnel resources are insufficient to allow timely posting and monitoring of accounting data during the year. Draft financial statements were not available for

Employees' Retirement System of the State of Rhode Island Schedule of Findings and Recommendations

audit until ten months after the close of the fiscal year. There is no timely and consistent management oversight of accounting data to ensure adherence to controls over financial reporting and to ensure data reported by the accounting system is accurate and consistent with normally expected results.

Refine the Accounting System to Meet ERSRI's Financial Reporting Needs

ERSRI implemented a new accounting system, known as ANCHOR, during fiscal 2002 which was designed to meet both its operational and financial reporting needs. During fiscal 2004 most functions of the system became fully operational, however, in certain instances the system is not currently meeting the financial reporting needs of ERSRI. Balances reported by the system, most notably 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. At times, these operational objectives, in their current form, are inconsistent with financial reporting 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 data base. From a financial reporting perspective the contributions have been "earned" and should be reflected as revenue in the general ledger. Similarly, the State's matching contribution for teachers is not recorded until all contribution data has passed 100% of the system edits. For financial reporting purposes, revenue should be recognized as contributions to the system are due based upon employer payroll activity.

ERSRI should review each of the major transaction types and assess how the Anchor and general ledger accounting systems handle the transactions and whether the data is consistent with financial reporting objectives. When the operational and financial reporting objectives are not consistent, ERSRI should explore options to make them consistent or develop specific data sources to meet financial reporting needs.

RECOMMENDATION

4. Identify ANCHOR processes that are not consistent with financial reporting objectives. When inconsistencies are found, explore options to make them consistent or develop specific data sources to meet financial reporting needs

Auditee Views:

ERSRI concurs with this recommendation. ERSRI designed the ANCHOR system with a focus of enhancing and expediting member and employer services. Member's ability to perform on-line benefit estimates and employer on-line contribution reporting are specific examples of these efforts. With implementation complete, ERSRI has formulated a work-group to evaluate the system to ensure processes line up with financial reporting objectives.

**Employees' Retirement System of the State of Rhode Island
Schedule of Findings and Recommendations**

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 each month and 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.

RECOMMENDATION

5. Develop 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:

ERSRI concurs with this recommendation.

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

During fiscal 2004 and through the time of our audit, ERSRI had insufficient personnel devoted to accounting functions. A key position, Assistant Director - Finance, was vacant for nearly a year. Consequently, numerous accounting functions were not performed timely and there was limited oversight of accounting and financial reporting functions. The Executive Director became directly responsible for posting journal entries and preparing the draft financial

**Employees' Retirement System of the State of Rhode Island
Schedule of Findings and Recommendations**

statements. The lack of accounting resources contributed to the delay in preparing financial statements and severely weakened controls over financial reporting.

RECOMMENDATION

6. Reassess existing accounting resources with the goal of ensuring that all key accounting and financial reporting functions can be accomplished within a reasonable time frame. Ensure adequate accounting resources exist to monitor control procedures and provide oversight of key accounting and financial reporting functions.

Auditee Views:

ERSRI indicates that early in FY2004, management sought support for additional FTE's to expand the accounting division. In response, the General Assembly approved 3 additional FTE's, while a vacant FTE in Treasury's policy division was also transferred to ERSRI's accounting division.

It was also recognized that the division of labor did not complement the new computer system. A project sub-committee was formed in early FY2004 to identify the appropriate separation of accounting, benefit, and hybrid functions; realign staff accordingly; rewrite job specifications to follow the line of business, including those duties new to the accounting division; and reassign management responsibilities to better reflect the division of accounting and benefit processes. The reconfiguration process will be complete by fiscal 2005 year-end.

FINDING 2004-3

**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.

We determined that there were no current operational procedures in place mandating that this reconciliation procedure detailed above, or any other type of reconciliation, be performed on a daily or 'as required' basis. This reconciliation process had not been performed, on any type of scheduled basis, since some point back in calendar year 2002.

Employees' Retirement System of the State of Rhode Island Schedule of Findings and Recommendations

In early 2003, the ERSRI commissioned a consultant to perform a review of the reconciliation process to determine if “any additional totals, reports processes or steps are needed to make the procedure more user friendly, complete and comprehensive”. Another objective of this review called for this report to provide recommendations for improvement to these procedures.

The consultant recommended creation of new automated procedures that would electronically match both detail and summary data and, as required, generate “out of balance” reports listing detail and summary amounts that do not ‘match’ between the two systems. ERSRI personnel indicated there had been an initial review of this study but no definitive corrective action has been taken. Recently, ERSRI, working with its systems consultant, started to revisit this area of concern.

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.

RECOMMENDATIONS

7. Determine the current validity of the consultant’s findings and recommendations relative to the reconciliation function between the ANCHOR and PeopleSoft components of the ERSRI accounting system.

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

Auditee Views:

ERSRI acknowledges reconciliation is a critical control feature, hence the required feature in the original system specifications. ERSRI is reviewing the current validity of the consultant’s findings and recommendations with the addition of the final phase of system implementation occurring during fiscal year 2004.

Presently, ERSRI has determined certain recommendations require modification to overall system reconciliation. In addition, recent staff realignment to the accounting department will provide for a daily high level system reconciliation to begin while analysis of detailed reconciliation is developed and implemented.

**Employees' Retirement System of the State of Rhode Island
Schedule of Findings and Recommendations**

FINDING 2004-4

**IMPROVE CONTROLS OVER DATA ENTRY TO ENSURE CORRECT POSTING OF
DATA TO EMPLOYER ACCOUNTS**

During fiscal years 2002, 2003 and 2004 data entry errors occurred which resulted in incorrect postings of contribution data to employer accounts. Because the system did not permit correction of this type of error, offline manual records of contributions by employer were maintained to supplement system generated data. Data contained within the system that is known to be inaccurate thereby necessitating offline records is problematic and compromises the reliability of all system reported data. These errors impact the accurate reporting of contributions and contributions receivable by employer unit.

Additional training and controls need to be implemented over the data entry process to ensure that data is correctly entered in to the system. When errors do occur, the system should allow, with appropriate controls, for correction of the erroneous data. ERSRI has requested that its system consultant modify the system to allow for correction of data entry errors.

RECOMMENDATIONS

9. Implement additional training as needed to reduce data entry errors for employer contributions. Enhance controls over data entry to limit the opportunity for error.

10. Accelerate implementation of the system modification that will allow for correction of errors to employer contribution accounts.

Auditee Views:

ERSRI concurs with these recommendations. A system enhancement to allow for correction of data entry errors is scheduled for implementation by fiscal 2005 year end. ERSRI will review and implement controls to mitigate entry errors. ERSRI has made staffing modifications to enhance controls and will continue to implement training as needed.

**Employees' Retirement System of the State of Rhode Island
Schedule of Findings and Recommendations**

OTHER FINDINGS AND RECOMMENDATIONS

FINDING 2004-5

ENHANCE MONITORING OF INVESTMENT COMPLIANCE

The State Investment Commission (SIC) is responsible for establishing guidelines and policies for investment of the ERSRI pension trust funds. The SIC does not directly manage the day-to-day investment of the portfolio but instead has adopted an asset allocation model with various external managers responsible for investing portfolio segments consistent with the SIC's directives. The SIC, assisted by staff of the Office of the General Treasurer and external consultants, primarily assumes an oversight and monitoring function. The staff of the Office of the General Treasurer should enhance certain monitoring and oversight procedures by performing more timely and comprehensive reviews of available data to ensure that investment managers and investment custodians adhere to established guidelines and directives.

A report on internal control procedures of the investment custodian ("SAS 70 report") is prepared for each semi-annual period by an independent certified public accounting firm and made available to all the custodian's clients. General Treasurer staff should document their review of the "SAS 70" report and inform the SIC of any significant issues or concerns raised by the custodian's auditors regarding deficiencies in control procedures or their application. The custodian has responsibility for all custody, recordkeeping, valuation, and settlement of trades for the ERSRI pension trust fund assets (excluding investments in commingled funds).

Each manager engaged by the SIC to invest a portion of the overall ERSRI portfolio is given a specific investment objective and guidelines. These guidelines include delineation of permitted and prohibited investments. The Office of the General Treasurer monitors investment manager performance using data available from the investment custodian, data provided directly by the investment managers (including presentations to the SIC), and information provided by the SIC's general consultant. Monitoring of manager compliance with their specific guidelines including permitted and prohibited investments should be improved in the following areas:

- ε Approximately 36% (\$2.2 billion) of the ERSRI pension trust fund assets were held (at June 30, 2004) in commingled funds. Commingled funds represent pooled assets of multiple institutional investors pursuing a common investment objective. Assets of the commingled funds are not held directly by the ERSRI investment custodian. Data available on a daily basis is limited to the aggregate fair value of the investment in the commingled fund. Monitoring of the commingled funds presents unique challenges because of the lack of transparency normally provided through the custodian. Annual audited financial statements of the commingled funds had been obtained for some, but not all, of the commingled funds held by the ERSRI. General Treasurer staff should obtain all audited financial statements of the commingled funds and document their

Employees' Retirement System of the State of Rhode Island Schedule of Findings and Recommendations

review. Review of the financial statements provides some relevant information regarding the specific investments of the commingled funds, its accounting practices, compliance with its specific investment objective, and other disclosures. Additional monitoring procedures may be necessary to ensure compliance, particularly as this segment of the ERSRI portfolio increases.

- £ “Ad hoc” reporting and monitoring services provided by the custodian can be effective tools available to the Office of the General Treasurer to monitor the ERSRI investment portfolio (exclusive of commingled funds). Analyses can be performed to ensure investment managers are complying with the directives of the SIC regarding permitted investments, prohibited investments, and investment objectives. These services were not utilized to their full potential due to fact that the custodian recognized improvements were needed to the product. As the custodian further refines this product, General Treasurer staff should use these tools to improve its overall compliance monitoring efforts.

RECOMMENDATIONS

11. Document review of service organization auditor reports and inform the SIC of any significant issues or concerns raised by the custodian’s auditors regarding deficiencies in control procedures or their application.
12. Obtain all audited financial statements of commingled fund investments and utilize this data and other information to enhance monitoring of the commingled funds.
13. Continue to work with the custodian to enhance utilization of the custodian’s “ad hoc” analytical and reporting services to ensure investment managers are complying with SIC directives regarding permitted investments, prohibited investments, and investment objectives.

Auditee Views:

The Office of the General Treasurer concurs with these recommendations.

Going forward, Treasury staff will document review of the “SAS 70” reports. It is Treasury policy for staff to apprise the SIC when any issue or concern arises. The independent service auditors’ reports on internal control procedures of the investment custodian have indicated that the custodian’s control procedures were suitably designed and operating effectively.

The Office of the General Treasurer believes that the commingled funds referenced, given their passive nature, require less monitoring than actively managed separate accounts.

Treasury staff will obtain all commingled fund annual financial statements (in either electronic or hard copy format) and will utilize the lagged data contained therein for

Employees' Retirement System of the State of Rhode Island
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monitoring purposes to the extent practical along with continued use of quarterly audited information provided by the plans general investment consultant and monthly and annual information provided directly by the investment managers of the commingled funds.

Treasury staff will continue to suggest and request that enhancements are made to monitoring tools provided by the custodian. Treasury staff has begun training on the new monitoring product.

FINDING 2004-6

**IMPROVE ACCUMULATION OF INVESTMENT INFORMATION NEEDED TO
PREPARE FINANCIAL STATEMENTS IN CONFORMANCE WITH GAAP**

A significant portion of the information needed to prepare the ERSRI annual financial statements relates to the System's investments. ERSRI is responsible for preparing the financial statements, however, the investment function is administered by the Office of the General Treasurer. Because of this division of responsibility, staying current with generally accepted accounting principles and disclosure requirements as they relate to investments is not clearly vested with either group. ERSRI management is responsible for preparing financial statements in accordance with generally accepted accounting principles (GAAP). Accordingly, we believe ERSRI should have primary responsibility and take the lead in staying current with generally accepted accounting principles and coordinating the accumulation of data for financial reporting purposes.

A portion of the ERSRI investment portfolio is allocated to "alternative investment managers" which may include real estate, venture capital and other non security-type investments. As required by generally accepted accounting principles, all ERSRI investments should be reported at fair value in the financial statements. By their nature, alternative investments are more challenging to present at fair value because valuation data is not as easily obtained. Accounting issues (some alternative investment managers follow tax-basis accounting rather than fair value), and timing issues (valuation is typically performed at calendar year end in conjunction with an annual audit rather than the ERSRI fiscal year end - June 30) further complicate the valuation. Analysis and accumulation of data should be enhanced for alternative investment managers to ensure that the "alternative investments" are reported at management's best estimate of fair value in the financial statements as required by generally accepted accounting principles.

Various disclosures regarding the System's investments are required to be included within the financial statements. Certain of these relate to "derivative" investments. ERSRI's existing information regarding derivative type investments does not sufficiently meet the objective of the required disclosures.

**Employees' Retirement System of the State of Rhode Island
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A workgroup should be established with both ERSRI and General Treasurer personnel to (1) identify all required investment information (including derivative type investment disclosures) needed to prepare financial statements and (2) explore the options for accumulating the information from either internal or external sources (e.g., investment custodian, managers, consultants).

RECOMMENDATION

14. Establish a workgroup comprised of ERSRI and General Treasurer personnel to identify all required investment information needed for financial reporting and explore options for accumulating the data. Assign responsibility for leading the effort to accumulate investment data needed for financial reporting to ERSRI.

Auditee Views:

ERSRI concurs with this recommendation and will continue to improve the annual investment reporting process via establishment of a workgroup comprised of ERSRI and General Treasurer personnel. Working with General Treasurer personnel, as in the past, responsibility for leading the effort related to disclosure and reporting will continue to be provided by ERSRI.

Office of the General Treasurer staff has suggested that investment managers provide detailed descriptions of what types of derivatives are utilized. The Office of the General Treasurer notes that investment managers' use of derivatives is restricted to hedging purposes only and that they are prohibited from using derivatives for leverage purposes.

FINDING 2004-7

**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

**Employees' Retirement System of the State of Rhode Island
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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 supports 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

15. 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.

FINDING 2004-8

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

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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

16. 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.