STATE OF RHODE ISLAND

EMPLOYEES' RETIREMENT SYSTEM

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*

and

Management Comments

FISCAL YEAR ENDED JUNE 30, 2014

Dennis E. Hoyle, CPA
Auditor General

Office of the Auditor General
General Assembly - State of Rhode Island

Office of the Auditor General
State of Rhode Island and Providence Plantations - General Assembly
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September 10, 2015

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER Nicholas A. Mattiello, Chairman

Senator M. Teresa Paiva Weed
Senator Dennis L. Algiere
Representative John J. DeSimone
Representative Brian C. Newberry

We have audited the financial statements of the Employees' Retirement System of the State of Rhode Island (the "System") for the year ended June 30, 2014 and have issued our report thereon dated December 18, 2014. The System's financial statements and our independent auditor's report thereon are included in a separate audit report entitled *STATE OF RHODE ISLAND EMPLOYEES' RETIREMENT SYSTEM - FISCAL YEAR ENDED JUNE 30, 2014.*

In accordance with *Government Auditing Standards*, we have also prepared a report included herein on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts. We reported no matters deemed significant deficiencies or material weaknesses in internal control or material noncompliance.

We have reported various matters included herein as management comments which include recommendations to enhance internal control or result in other operational efficiencies.

Sincerely,

Dennis E. Hoyle, CPA
Auditor General

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

FISCAL YEAR ENDED JUNE 30, 2014

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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, in accordance with the 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, the financial statements of the plans within the Employees' Retirement System of Rhode Island (System) as of and for the year ended June 30, 2014 and the related notes to the financial statements, which collectively comprise the System's basic financial statements, and have issued our report thereon dated December 18, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Joint Committee on Legislative Services, General Assembly
Retirement Board of the Employees' Retirement System of the State of Rhode Island:

Compliance and Other Matters

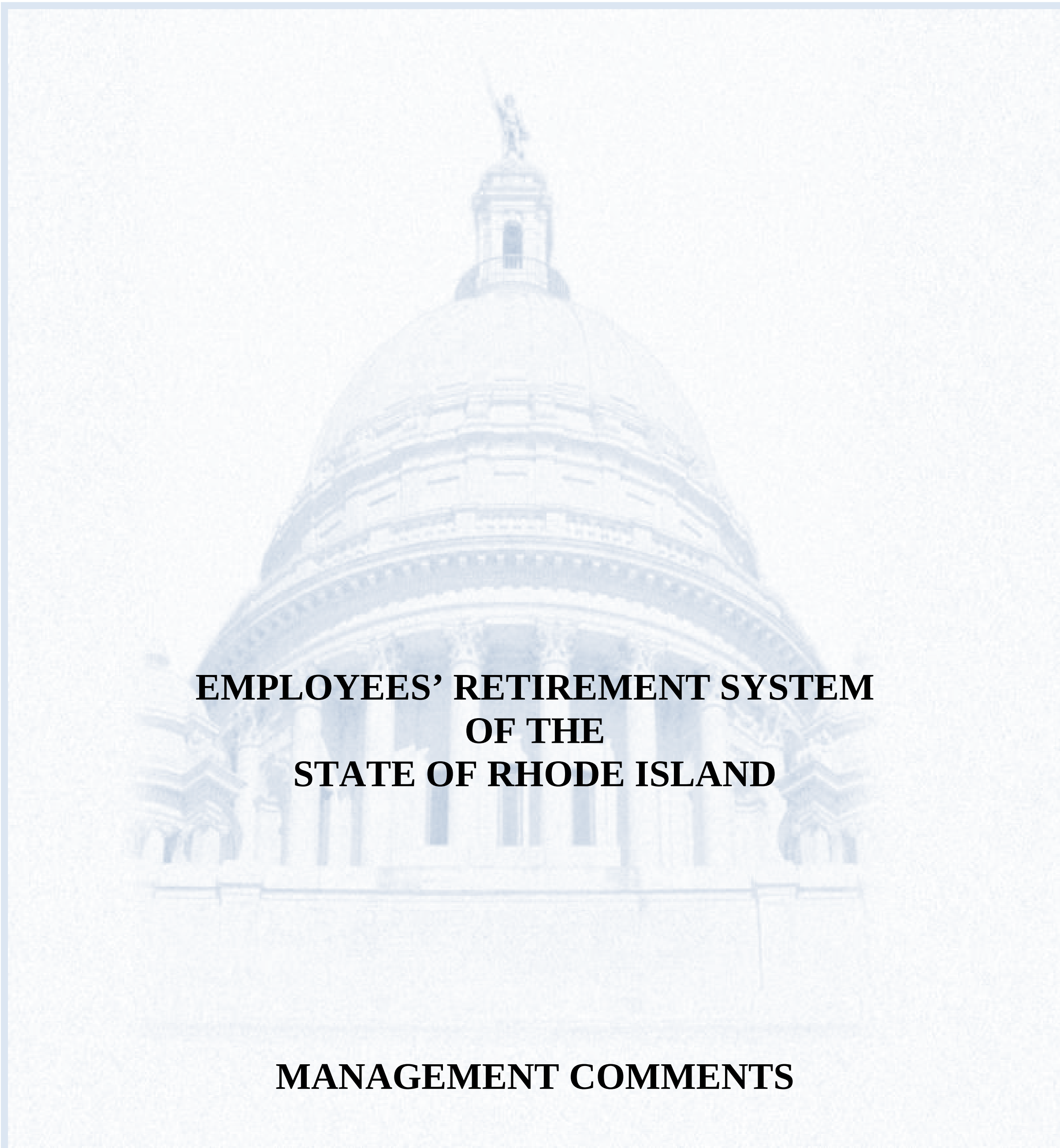
As part of obtaining reasonable assurance about whether the System's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material 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*

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Dennis E. Hoyle, CPA
Auditor General

December 18, 2014



EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

MANAGEMENT COMMENTS

Management Comment 2014-1

ENSURE ADEQUATE RESOURCES ARE COMMITTED TO MEETING THE SYSTEM'S CRITICAL ACCOUNTING, FINANCIAL REPORTING, AND PARTICIPATING EMPLOYER FINANCIAL REPORTING NEEDS

The System has multiple critical accounting/financial reporting challenges that are ongoing and demand significant resources. These include implementation of a new computer system and implementation of GASB Statement No. 68 - *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*. While GASB Statement No. 68 affects the financial reporting of the System's participating employers, the System along with its actuary and auditor (Office of the Auditor General) must collectively provide the information that will allow the employers to meet their financial reporting requirements under generally accepted accounting principles. There is a significant amount of information to be reported annually particularly for the System's cost sharing plans (ERS – covering state employees and teachers and the Teachers Survivors Benefit plan) and the agent multiple employer plan (MERS). In essence, specific information for each participating employer must be prepared, audited, and reported.

The computer system installation requires a peak effort over the next two years. The GASB Statement No. 68 accounting standard implementation is most challenging in 2015 but will continue to require consistent effort each year so that all the System's participating employers can meet their annual financial reporting needs. Further, the implementation of GASB Statement No. 68 will require training and outreach for the participating employers and their auditors to coordinate the implementation and use of the new information.

All these efforts essentially involve and draw upon the same personnel resources. The System must ensure that adequate resources are available and committed to meet these significant and time sensitive efforts.

<u>RECOMMENDATION</u>

2014-1 Assess the adequacy of staff resources available and committed to the significant accounting and financial reporting tasks facing the System.

<u>*Auditee Views and Corrective Action Plan:*</u>

ERSRI recognizes the challenges and magnitude of implementing GASB 68 in FY2015. Over the past two fiscal years ERSRI has hired additional accounting resources to address the implementations of GASB 68 and the new information technology systems.

In addition, ERSRI has created a working group consisting of the Auditor General, ERSRI's actuary, and ERSRI management to develop a plan for implementation of GASB 68 for financial reporting and training of participating employer units and their auditors.

ERSRI will continue to assess the need for additional accounting resources as the implementation of this accounting pronouncement and the installation of ERSRI's information technology upgrades evolve in future fiscal years.

Management Comment 2014-2

PENSION FUNDING POLICY

The Governmental Accounting Standards Board (GASB) newly effective pronouncements (GASB Statements No. 67 and 68) regarding accounting for pension liabilities and related costs had a significant impact first on the financial statements of governmental pension plans in fiscal 2014 and again in fiscal 2015 for the financial statements of employers participating in governmental plans.

One of the many provisions of these pronouncements particularly worthy of note is the "delinking" of accounting requirements from pension funding policies.

Previously, under prior statements issued by the GASB for pensions, accounting guidance was also used as the basis for "acceptable" funding policies with GASB defining acceptable actuarial methods, amortization periods etc. Under the newly effective guidance (GASB Statements No. 67 and 68) GASB only defines the **accounting** and disclosure requirements for pensions to be included in the financial statements of governments. These accounting measures are likely unsuitable for funding purposes and determining actuarially determined contributions. For example, the accounting measures for determining the net pension obligation to be included on a governmental statement of net position (balance sheet) reflects the fair value of pension plan assets at that date. For funding purposes, most plans use "asset smoothing" (generally over five years) that tempers the volatility in required contribution rates due to significant market valuation changes in any one year.

Consequently, most governments will need to separately adopt funding policies to guide their funding decision over time while using the accounting measures in their financial statements prepared in accordance with generally accepted accounting principles.

Many of the funding policies employed for the defined benefit pension plans administered by the Employees' Retirement System of Rhode Island are outlined in statute; however, in many instances these General Laws reference prior GASB guidance (GASB Statements No. 25 and 27) regarding permitted actuarial methods, amortization periods etc. which will no longer be effective or exist as appropriate funding guidance.

In response to the new GASB pension standards, organizations such as the Government Finance Officers Association and others are recommending that governments establish and adopt comprehensive pension funding policies, which outline all the key provisions designed to responsibly fund a pension plan and calculate the employer actuarially determined contribution.

In Rhode Island, pension funding policies are a combination of legislatively enacted statutes and other measures adopted by the Board of the Employee's Retirement System. The new environment may require amendment of existing statutes in certain instances to eliminate outdated GASB references regarding permitted actuarial methods and the accumulation of comprehensive pension funding policies that include statutory measures and other provisions adopted by the Board of ERSRI.

Lastly, the new environment will require education for all to appreciate the differences between the accounting and funding measures of pension liabilities. These measures will be different and may present opportunities for potential misunderstanding regarding which measure is most appropriate for use by decision makers in various situations.

RECOMMENDATION

2014-2 Develop and adopt a formalized pension funding policy that incorporates statutory provisions as well as funding and actuarial policies approved by the Board of the Employees' Retirement System.

Auditee Views and Corrective Action Plan:

ERSRI does have a funding policy, by virtue of the ERSRI Board approving an actuarial valuation report as prepared by the System's actuary. Within the valuation of each Trust the valuation report defines the System's funding policy and financing objectives. As a result of the approval of each valuation by the Board and what is prescribed in statute ERSRI believes it does have an acceptable funding policy for fiscal year end 2015 and into the foreseeable future.

ERSRI did concur with the auditor in 2014 that with the implementation of GASB 68 technical amendments to existing statutes for the System's funding policy required corrective action to eliminate outdated GASB references regarding permitted actuarial methods and the accumulation of comprehensive pension funding policies. Accordingly, such changes were enacted in Article 21 of the 2015 legislative session budget.

ERSRI will review and consider formal adoption of pension funding policy contained in the actuarial valuation.

Management Comment 2014-3

GASB STATEMENT NO. 67 REQUIRED INFORMATION – LONG-TERM EXPECTED REAL RETURN BY ASSET CLASS

The System implemented GASB Statement No. 67 - Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25 for fiscal 2014, which required, among other things, the disclosure of the long-term expected rate of return for each asset class within the System's target asset allocation (as adopted by the State Investment Commission). The purpose of the disclosure is to demonstrate the support for the System's overall investment rate of return assumption (currently 7.5%). The System should enhance its compliance with the new accounting disclosures by requesting additional information from its actuary and investment advisors.

The information available to the System for fiscal 2014 did not completely align with the new disclosure requirement. In an experience study performed by the System's actuary during fiscal 2014 (as of June 30, 2013), the actuary affirmed the System's investment return assumption of 7.5%. This was based on capital market earnings assumptions prepared by eight recognized investment consulting firms. The actuary's experience study, while affirming the System's rate of return assumption, did not include specific real rate of return expectations for each asset class. The State Investment Commission's (SIC) investment advisor provided the SIC with a medium-term (10-year horizon) earnings expectation for each of the target asset allocations adopted by the SIC for the pooled investment trust.

These medium-term, rather than long-term, earnings expectations by asset class were used to meet the disclosures within the System's 2014 financial statements. The financial statement disclosures included appropriate explanations of the difference in the time horizon (10 vs. 30 years) and that the actuary adjusted the medium-term expected real return rates to an equivalent long-term expectation in preparing his actuarial valuations of the plans within the System. In the future, the System should coordinate with its actuary and the SIC's investment advisor to obtain the specific long-term real return expectations for each target asset allocation.

The System should ensure that the information available to meet the disclosure of real rates of return for each asset class better aligns with the GASB Statement No. 67 requirements.

RECOMMENDATION

2014-3 Request long-term expected real rates of return by target asset allocation from the actuary and investment advisor to enhance disclosure of such information in the System's annual financial statements as required by generally accepted accounting principles.

Auditee Views and Corrective Action Plan:

While continuing to remain in compliance with generally accepted accounting principles ERSRI will continue to work with the System's actuary, investment advisor, and Chief Investment Officer to develop long-term expected real rates of return for financial reporting purposes.

Management Comment 2014-4

INVESTMENT ACCOUNTING

Investment staff within the Office of the General Treasurer who are responsible for overseeing the System's investment portfolio are organizationally separate from the Retirement Division and consequently independent from the accounting and financial reporting processes of the Division. By statute, investment decisions are made by the State Investment Commission whereas all other System activities are overseen by the Board of the Employees' Retirement System. This contributes to a split responsibility for (1) information included within the System's financial statements and (2) the design and operation of key controls over financial reporting.

There is a significant amount of investment information that is reported within the System's financial statements. Additionally, for any pension plan, investment activity is a key operational and control functionality. Management should consider ways to better integrate these organizational areas to enhance controls over financial reporting with regard to investments and related disclosures. This includes ensuring that those individuals responsible for preparing the System's financial statements have enhanced oversight for financial reporting of important investment activities.

RECOMMENDATION

2014-4 Enhance controls over financial reporting by better integrating responsibility for the investment cycle with all other System activities.

Auditee Views and Corrective Action Plan:

As the Auditor notes, the State Investment Commission has fiduciary responsibility for all investment-related decisions, and Treasury's investment staff oversees the reporting, monitoring and safekeeping of the investments. The investment staff works closely with the custodian, a third-party specialist who ensures the integrity of financial data pertaining to investments, including validating investment valuations.

The investment staff, which has the necessary expertise, gathers and filters the financial information for investments and provides it to the Retirement Division, which consolidates it into the overall ERSRI financial statements. Through this process, the System's financial statements include all relevant investment activities in accordance with generally accepted accounting principles.

Treasury management is continually looking for ways to improve and better integrate accounting functions across the Investment and Retirement Administration divisions. By way of example, as part of its strategic plan, Treasury management will formally request additional accounting resources for the retirement system in its FY17 operating budget.

Management Comment 2014-5

ENGAGE A CONSULTANT TO ASSIST IN PREPARING DERIVATIVE INVESTMENT DISCLOSURES

Generally accepted accounting principles require specific disclosures about derivative investments held within the System's investment portfolio. By their nature, these are complex financial instruments typically used to gain exposure to a particular asset allocation target or to hedge a specific risk such as foreign currency conversion. Interpreting both the unique aspects of the derivative investments and the required accounting disclosures can be challenging for the relatively small investment oversight staff within the General Treasurer's Office. Since preparing these financial statement disclosures is an annual rather than recurring task, it may be efficient to engage a consultant for this specific task. This would enhance the System's ability to ensure the annual financial statements conform with generally accepted accounting principles.

RECOMMENDATION

2014-5 Engage a consultant to assist in preparing derivative investment disclosures required for the System's annual financial reporting.

Auditee Views and Corrective Action Plan:

Derivatives are standard investment tools in which the System's portfolio has long invested to craft a portfolio that can achieve the Retirement Board's mandated return target.

Similar to other investments (cash, foreign exchange, etc.), generally accepted accounting rules require specific disclosures about derivative investments. The nature and type of derivative exposure has been consistent for the past several years. Working with resources provided by the system's Master Custodian, Treasury management is comfortable with the consolidated data presented in the notes to the financial statements regarding derivative exposure in the System's portfolio. Also, these investments represent a very small percentage of the total portfolio value throughout the fiscal year and are generally collateralized with less than 0.01% of the portfolio.

Also, as discussed in our response to MC 2014-04, improved and better integrated accounting functions within the Investment and Administration divisions will afford an opportunity to strengthen the presentation of derivative investment disclosures.

Treasury management would consider engaging additional external resources if the nature and exposure of derivative instruments were to expand substantially beyond their current role in the portfolio.

Management Comment 2014-6

SEEK FORMAL INTERNAL REVENUE SERVICE DETERMINATION OF THE QUALIFYING STATUS OF EACH DEFINED BENEFIT and DEFINED CONTRIBUTION PENSION PLAN

Governmental pension plans operate under unique Internal Revenue Service (IRS) code provisions. Certain of these provisions relate to the taxable treatment of member contributions to the plan as well as benefits paid from the plan. The IRS has various requirements relating to a pension plan being established and maintained as a qualified governmental plan.

The System has not sought formal determination letters from the IRS confirming the qualifying status of all the System's defined benefit and defined contribution plans. The State did enter into an "Agreement as to Final Determination of Tax Liability and Specific Matters" with the IRS in 1994 primarily to resolve issues related to the prior withdrawal of contributions. That agreement addressed various plan compliance matters. TIAA-CREF, as the plan administrator/record keeper for the defined contribution plan sought and received pro-forma plan type approval from the IRS for that plan but the approval was not plan specific.

Available information suggests that "best practices" for governmental pension plan administration include obtaining a formal determination from the IRS regarding the qualifying status of the pension plan and then maintaining such qualification consistent with IRS guidelines. The IRS, in a document released in November 2013, noted that although "submitting a request for a determination letter is voluntary, there are compelling reasons to apply for one. For example, a favorable letter allows the plan to:

- minimize the risk that the IRS will disqualify the plan on audit because the plan document doesn't satisfy the applicable tax-qualification requirements, and

- use certain IRS correction programs to correct plan errors."

We understand that a large part of obtaining a formal determination requires submission of plan documents which address all the required areas of the IRS regulations. The Executive Director informed us that legal staff have begun accumulating all necessary plan documents with the intent of seeking a formal determination. We are not aware of any information indicating that the plans do not meet the IRS requirements of a qualified plan.

RECOMMENDATION

2014-6 Seek formal determination letters from the Internal Revenue Service regarding the qualifying status of the System's defined benefit and defined contribution plans.

Auditee Views and Corrective Action Plan:

ERSRI has in fact received a determination IRS letter, for specific topics addressed by the IRS, entitled "Tax Liability and Specific Matters" dated February 4, 1994 in which the IRS noted that the plan is intended to be a qualified plan under section 401(a) of the IRS code. As required by the letter, Rhode Island General Laws were amended in the 1994 legislative session to add RIGL 36-8-20 Internal Revenue Code Qualification. In addition, the Plan meets the definition of a Governmental plan as defined by IRS under sections 414(d) and (h), and 415.

Regarding the defined contribution plan, the plan has an IRS approval letter dated March 31, 2014 reference TEGE:EP:7521.

ERSRI recognizes that receiving an IRS determination letter is generally accepted as a "best practice" and will continue its efforts to obtain one and will plan to engage additional resources for completion.

Management Comment 2014-7

SYSTEM ADMINISTRATIVE COSTS

The administrative costs of operating the retirement system are allocated to and paid from the plans within the System. These include the (1) direct costs of operating the System such as personnel costs for employees of the Retirement Division, actuarial, custodial and investment manager fees, and (2) allocated personnel costs for certain members of the General Treasurer's staff who spend a portion of their time on retirement system related activities.

The Employees' Retirement System Board should formalize a policy regarding which administrative costs are to be paid from the plans within the System. This would provide guidelines for the consistent determination and allocation of such costs to the System in keeping with the Board's fiduciary responsibility. The administrative costs charged to the System are a component (albeit small) of the calculation of the actuarial rate of return which is an important element of the actuarial valuations performed of the plans and a determinant of whether a cost of living adjustment (COLA) will be paid and the amount of such COLA.

A formal policy would additionally provide guidance when either unusual or new expenses arise and a decision must be made regarding whether the item should be charged as an expense of each pension trust. Current examples include legal defense fees related to challenges to the enactment of the Retirement Security Act of 2011 and the anticipated increased actuarial fees related to new accounting standards (GASB Statements 67 and 68) implemented in fiscal years 2014 and 2015.

During fiscal 2014, the System began allocating certain of its administrative costs related to the oversight of the defined contribution plan administered by TIAA-CREF from the fees charged to each plan participant.

Additionally, there are other trust funds in addition to the Employees' Retirement System, which could receive an allocation of certain costs if the goal is to equitably distribute such costs based on proportionate effort. For example, the OPEB Trust funds were created in fiscal 2011. Currently, applicable investment custodial fees are allocated to the OPEB Trust funds; however, no General Treasurer investment division costs are allocated - unlike the allocation to the Retirement System trust funds.

We noted that a summary budget outlining the costs to be charged to the System is presented to the Board annually but personnel costs for Treasury staff are presented in aggregate without a personnel supplement delineating the positions charged or partially allocated to the System. Information available to the Board would be enhanced through providing additional detail information on the Treasury positions funded through the System.

As fiduciaries of the plans within the System, the Board's approval of administrative costs would supplement the annual legislatively approved appropriation for the System from a restricted receipts account within the State's General Fund. A formal policy statement would guide (1) which costs are deemed appropriate as expenses of the various trusts within the System and (2) the equitable distribution of such expenses when shared by multiple plans/trusts.

RECOMMENDATIONS

2014-7a Formalize ERSRI Board policy regarding administrative costs to be charged to the Employees' Retirement System.

2014-7b Provide enhanced budgetary information to the Retirement Board regarding administrative costs charged to the System including a personnel supplement detailing direct and allocated positions.

2014-7c Ensure the allocation methodology used to distribute administrative costs to all the benefitting trust funds results in an equitable distribution of such costs.

Auditee Views and Corrective Action Plan:

Regulation 1(A) 5(10) of the Employees' Retirement System of Rhode Island provides authority to the Retirement Board to approve an annual budget. ERSRI management has continued to provide clarity and detail regarding allocation of expenses of System to the board during the budget approval process.

Management Comment 2014-8

COMPLETE IMPLEMENTATION OF THE INFORMATION TECHNOLOGY GOVERNANCE AND STRATEGIC PLAN

ERSRI has created an Information Technology Governance and Strategic Plan to be utilized in the oversight of the Employees' Retirement System of Rhode Island which has been partially implemented. Implementation should continue in order to oversee the current ANCHOR system and PeopleSoft general ledger and guide ERSRI through the development and installation of their new computer system. Implementation of the plan would ensure that security, operational documentation, program change controls, user access rights, and equipment aspects of the System's overall IT governance structure have been adequately monitored within the current system and will be addressed through the installation and operation of the new system in development. Additionally, implementation of the IT Governance and Strategic Plan would also be useful as ERSRI moves forward with properly identifying and addressing the technical and security risks associated with "cloud computing" technology – the model selected for the new system development.

RECOMMENDATION

2014-8 Complete implementation of the IT Governance and Strategic Plan developed for ERSRI.

Auditee Views and Corrective Action Plan:

During FY2012, the System developed a comprehensive Information Technology Governance and Strategic Plan. In FY2014 the System entered into an agreement with an IT vendor to begin the transition from its legacy systems to a new line-of-business, accounting and payroll platform.

Revisions were made to the plan to ensure that it was reflecting the changing IT environment of ERSRI. The plan will be fully implemented after the new IT system is fully implemented to incorporate any necessary changes. In FY 2015 ERSRI will continue to identify the appropriate resources necessary for implementation of the plan.

Management Comment 2014-9

ENHANCE MONITORING OF THE CONSULTANT CHANGE MANAGEMENT PROCESS

Currently, ERSRI uses emails as a method of documenting and identifying authorized changes made to the ANCHOR application system. However, this process is not effective in identifying unauthorized changes made directly to the ANCHOR application system. Although the current process allows ERSRI management to track their initiated change requests and authorized changes initiated by the consultant, they do not receive or review on a periodic basis any change reports or logs to verify all changes made to the system. ERSRI relies on the documentation contained within their vendor's change management system to evidence changes that were made to the ANCHOR application system.

Management should monitor and verify on a periodic basis that only authorized changes are being made to the system and identify those changes that have not been authorized by ERSRI. Because contractor personnel must be provided broad access to all aspects of the system, procedures must be in place to mitigate the risk of unauthorized changes being made to the system and system data.

RECOMMENDATION

2014-9 Enhance oversight of the program change management function as performed by the System's contracted IT vendor. Receive and review change logs and determine if they are authorized and in accordance with documented management directives.

Auditee Views and Corrective Action Plan:

ERSRI has examined additional change management procedures as part of the IT Governance and Strategic Plan. The System maintains Change Control Request documentation when implementing major programmatic changes. Major changes are monitored through the change order process. Under ERSRI's system replacement, ERSRI will be able, at the vendor's premises, to conduct an audit (i) to confirm that security and data protection protocols utilized by the vendor comply with NIST or other industry acceptable standards; and (ii) to satisfy ERSRI's own audit or governance and oversight requirements.

Management Comment 2014-10

INCLUDE FUNCTIONALITIES IN ERSRI'S NEW COMPUTER SYSTEM

The Board of the Employees' Retirement System recently selected a vendor to replace the existing ANCHOR system as well as the interfaced general ledger software. The following items, which had been presented as findings and recommendations in prior year audits, should be addressed through inclusion of these functionalities within the development and implementation of the new computer system. Certain of these functionalities reflect current system development standards but may not be automatically included by the system contractor unless specified contractually. Others reflect current technology that might have been costly to retrofit within the current system but could be incorporated with relative ease in the development of the new system.

Accurate Member Service Credit Data

The System does not have accurate service credit data for some of its members. This is important data used by the System's actuary to calculate the funded status of the plans and the amount that employers contribute to the System.

Active members of the System earn service credits each year which ultimately determine the amount of their pension benefit. The computer system used by ERSRI prior to November 2001 did not maintain member service credit data. As a result, ERSRI estimated service credits based on date of hire and various other data elements and entered this information into the new ANCHOR computer system. ANCHOR was designed to track service credits for all members after its implementation in November 2001.

We have found that ERSRI's estimate of service credits recorded in the ANCHOR system has been generally accurate when the member had no breaks in service, worked full time and had no unusual situations. However, when that was not the case, errors in the service credits recorded in ANCHOR (for credits earned prior to November 2001) were noted. Service credits are recomputed and validated at the time of retirement; therefore, benefit payments are not impacted by the incorrect service credit data. However, actuarial valuations would likely be impacted although we cannot estimate to what extent.

In a prior audit we tested a statistical sample of approximately 19,135 active members as of June 30, 2010 that were hired before the ANCHOR system was operational. Our sample results indicated that approximately 10% of the members in this population may have inaccurate service credit data.

ERSRI should complete the process of identifying the member accounts that have errors. This will ensure that the functionalities of the new computer system will not be limited or affected by the inclusion of inaccurate service credit data for some members. The initial service credit data integrity issue goes back to 2001. We acknowledge that efforts to resolve the data integrity issues are labor-intensive and time-consuming; however, these issues will continue to impact even the new system, unless resolved.

RECOMMENDATION

2014-10a Develop a plan to review member records to ensure all member accounts have accurate service credit data.

Auditee Views and Corrective Action Plan:

ERSRI has and will continue to increase its efforts to validate accounts and will evaluate additional resources to perform data validations. Regarding actuarial valuations, ERSRI's actuary develops adjustments to mitigate the impact on the valuation if applicable.

Prior to the development of the ANCHOR system, member service credit was not a data element in the legacy system and was manually calculated using various other data elements. During ANCHOR development, algorithms were performed to calculate service credits from data available in the legacy systems. In tests of the applicable algorithms, calculation of service credit produced a 95% accuracy level.

Since the implementation of ANCHOR, technically trained staff has been working to validate accounts beyond an as-needed basis.

While the sample results indicated that approximately 10% of the members in this population may have inaccurate service credit data, the order of magnitude of inaccuracy has not been noted. While ERSRI strives to improve the accuracy of service credit for members ability to estimate benefits, small variations in service credit have limited impact on the valuation process.

Improve Cash Reconciliation Efficiency - Electronic Bank Reconciliations

The System should explore options to automate the cash reconciliation process for the System's bank accounts. Electronic matching could be facilitated by aligning transaction detail between the bank and the System's accounting system to minimize any differences.

RECOMMENDATION

2014-10b Explore options to increase automation of the reconciliation process with the System's financial institutions by seeking electronic bank reconciliation functionality within the new general ledger package.

Auditee Views and Corrective Action Plan:

The System has procured a new line of business system and general ledger package. Included in the proposal, the System has requested that the new line of business system and the general ledger package have the capability of performing electronic bank reconciliations. ERSRI will coordinate with the Treasury to facilitate this process and seek to implement (if determined feasible) between FY2015 and FY2016.

Membership Applications – Implement Online Membership Enrollment

The System currently mails a membership application to new hires, which then requires a paper submission back to the System. Member compliance with the requirement to timely submit a completed membership application could be improved. Membership enrollment and capture of critical member data should be automated and facilitated through enhanced on-line capabilities. The process could begin with initial information captured at the time of hire by the employer, including a determination of eligibility for membership. Additional data, such as the designation of beneficiaries, could be added by the employee, via on-line access, at a later point if necessary.

RECOMMENDATION

2014-10c Implement on-line membership enrollment as part of the implementation of the System's new computer system.

Auditee Views and Corrective Action Plan:

ERSRI has procured a new line-of-business system with on-line capability. Upon project completion, this process will be available.

Require Electronic Remittance of Contributions to the System

Member contribution data is uploaded to the ANCHOR computer system electronically; however, municipal employer units remit their contributions to the system by mailing a check to the System. The System should require electronic remittance of employer contributions to speed their availability thereby limiting the need to liquidate investments to meet the monthly pension benefit payroll. The impact on employer units should be minimal since most are already remitting federal and state withholding taxes and FICA contributions electronically as required by federal and state law and the cost to effect an electronic ACH payment is less than the cost to process a check. A change to the General Laws may be required to mandate electronic remittance of contributions for member units.

Additionally, the System should seek amendment to the General Laws, which currently requires that contributions to the System be remitted by the 15th of the month following the month in which the payroll was paid. Requiring remittance of contributions electronically within five business days of the payroll date would speed the availability of contributions to the system and is generally consistent with the remittance requirements for federal, state and FICA taxes paid by employers.

Accelerating the timing of contributions remitted to the System is important to minimize the amount of investments that need to be liquidated each month to meet the System's pension benefit payroll.

RECOMMENDATIONS

2014-10d Require member units to remit contributions to the System electronically rather than by check.

2014-10e Seek amendment to the General Laws to require remittance of contributions by employers within five business days of the payroll date.

Auditee Views and Corrective Action Plan:

The larger issue of liquidating investments each month to meet pension benefit payroll has limited, if any, relation to the timing of receipt of contributions. However, we do agree that the System should collect contributions electronically. The replacement line-of-business and general ledger systems will establish a process for the electronic remittance of contributions.

The Board's legislative subcommittee proposed language for submission in the 2014 session. The legislation sought to collect contributions from member units in a shorter time period than currently prescribed in Rhode Island General Laws. Subsequently, due to the constraints of the pending pension litigation, this proposed bill needed to be tabled pending outcome of the proposed settlement.

Log Changes to Critical System Data Elements

The ANCHOR system lacks the functionality to track and log changes made to selected/specific critical data elements. Currently, the ANCHOR system does not maintain a true "audit log" that captures and reports upon all changes made to critical data fields. ANCHOR maintains "history" tables; however, there is no automated method to extract and report upon any changes made to critical individual data elements.

As the new pension administration system will be cloud-based, it is critical that management know of any changes made, whether authorized or unauthorized, to individuals' retirement contribution or benefit data, since it could have a direct impact on future benefits paid to members.

RECOMMENDATION

2014-10f Include the functionality to log changes to critical system data elements within the new computer system under development.

Automated Application Change Management System

ERSRI currently lacks a fully automated change management system to track and identify all authorized and unauthorized changes to the ANCHOR application system. As the new pension administration and general ledger system will be "cloud-based", it is critical that ERSRI management be aware of and approve all changes made to both applications.

RECOMMENDATION

2014-10g Ensure that the new pension administration system has a fully automated application change management system in place, which will allow ERSRI to monitor and verify that all authorized changes were properly made, and to identify any unauthorized changes.

Auditee Views and Corrective Action Plan:

2014-10 f and g - ERSRI has made this a requirement in its system upgrade. The selected vendor will provide software and on-site auditing ability. Under ERSRI's system replacement, ERSRI will be able, at the vendor's premises, to conduct an audit (i) to confirm that security and data protection protocols utilized by the vendor comply with NIST or other industry acceptable standards; and (ii) to satisfy ERSRI's own audit or governance and oversight requirements.

Management Comment 2014-11

PROMULGATE AND CODIFY POLICIES FOR VARIOUS PENSION ADMINISTRATION ISSUES

Administration of the System is largely governed by specific statutes regarding membership, required contributions, actuarial matters, and benefit provisions. However, in certain instances, statutes are not specific to all situations and therefore various issues require judgment, interpretation of various statutes individually or collectively, consultation with the System's actuary, or decision by the ERSRI board. At times, precedent and past practices are used to guide various administrative decisions. The System has promulgated regulations covering a number of areas. We believe these regulations should be expanded to codify various policies which have been either formally or informally developed, and others which have not yet been established. Examples of the types of policies recommended for codification include:

- Determination of service credits for part-time employees;
- State employees who accrue service credits and then become members of the judiciary;
- Permitted post-retirement employment;
- Actuarial reductions taken in computing amounts paid to a beneficiary when a member dies in service;
- Use of the actuarial rate of return for determination of cost of living adjustment calculations; and
- Frequency of actuarial audits.

We recognize that ERSRI has accelerated the process to formalize and codify various policies and procedures and acknowledge this is a significant endeavor due to the complexity of the administration of the retirement system. However, that complexity supports the need to document and codify the many policies and procedures utilized in administering the System.

RECOMMENDATION

2014-11 Codify all existing polices and promulgate various informal policies used in the administration of the System.

Auditee Views and Corrective Action Plan:

ERSRI regularly publishes regulations that are approved and promulgated by the Board. ERSRI continues to update regulations and members' handbooks to support current business needs and will continue its work to codify various policies used in administration of the System. Additionally, information impacting the membership is posted on ERSRI's website. ERSRI is and has been in an ongoing effort to codify rules. ERSRI prioritizes the delivery of rules given the order of magnitude of an affected procedure or issue.

Management Comment 2014-12

REVISIT THE SYSTEM'S ANNUAL REPORT PROCESS

The System prepares an annual report as required by Section 36-8-8 of the General Laws. The report is to be submitted to the governor and legislative leaders "before the first day of December in each year… for the fiscal year of the state preceding said date".

The Retirement Division should revisit the current annual report process with the aim of ensuring information is available in the most timely and efficient manner. We suggest the Retirement Division explore amendment of the section of the General Laws (36-8-8) regarding the annual report to reflect a more current view towards the timeliness of financial data and also modify the other types of data currently required which is not provided in the System's annual reports. Further, the mode and manner in which System information is made available has changed dramatically since the enactment of the General Law provision. Audited financial statements are available on-line immediately upon completion of the audit and actuarial valuations are similarly made immediately available on-line upon acceptance by the Board. Consequently, a separate communication including these items nearly a year later becomes redundant and unnecessary.

The System may also wish to consider a "popular report" that is intended to provide a more summarized overview of the System's key financial information which could be appropriate for communication to members of the System and the general public. Other State retirement systems have issued "popular reports" and the Government Finance Officers Association has guidelines on the recommended content of such reports.

RECOMMENDATIONS

2014-12a Revisit the current annual report process with the aim of ensuring information is available in the most timely and efficient manner and propose revisions to the

General Laws regarding the content and or timing of such information as warranted.

2014-12b Consider issuing a "popular report" which readily summarizes key financial information on the System that could be a useful tool in communicating with plan members and the general public.

Auditee Views and Corrective Action Plan:

The timing of the production of the pension fund's valuation has been accelerated, which will also work to eliminate the reporting period differences. It should be noted that ERSRI has been in compliance with the law (RIGL §36-8-8) as it is currently written.

ERSRI concurs and will work with the Auditor General to consider revisions to Rhode Island General Laws for report preparation.