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*

Schedule of Findings and Responses

FISCAL YEAR ENDED JUNE 30, 2011

Dennis E. Hoyle, CPA
Auditor General

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

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS
GENERAL ASSEMBLY
OFFICE of the AUDITOR GENERAL

DENNIS E. HOYLE, CPA
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- *INTEGRITY*
- *RELIABILITY*
- *INDEPENDENCE*
- *ACCOUNTABILITY*

April 11, 2012

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER Gordon D. Fox, Chairman

Senator M. Teresa Paiva Weed
Senator Dennis L. Algiere
Representative Nicholas A. Mattiello
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, 2011 and have issued our report thereon dated December 12, 2011. 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, 2011.*

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 noted certain matters involving internal controls, and other operational matters that are presented for your consideration. These comments and recommendations are intended to enhance internal control or result in other operational efficiencies.

Sincerely,

Dennis E. Hoyle, CPA
Auditor General

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EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

FISCAL YEAR ENDED JUNE 30, 2011

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GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

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- *INTEGRITY*
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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 the statements of fiduciary net assets of the Employees' Retirement System of the State of Rhode Island (the System) as of June 30, 2011 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated December 12, 2011. 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

Management of the System is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

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 System's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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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 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.*

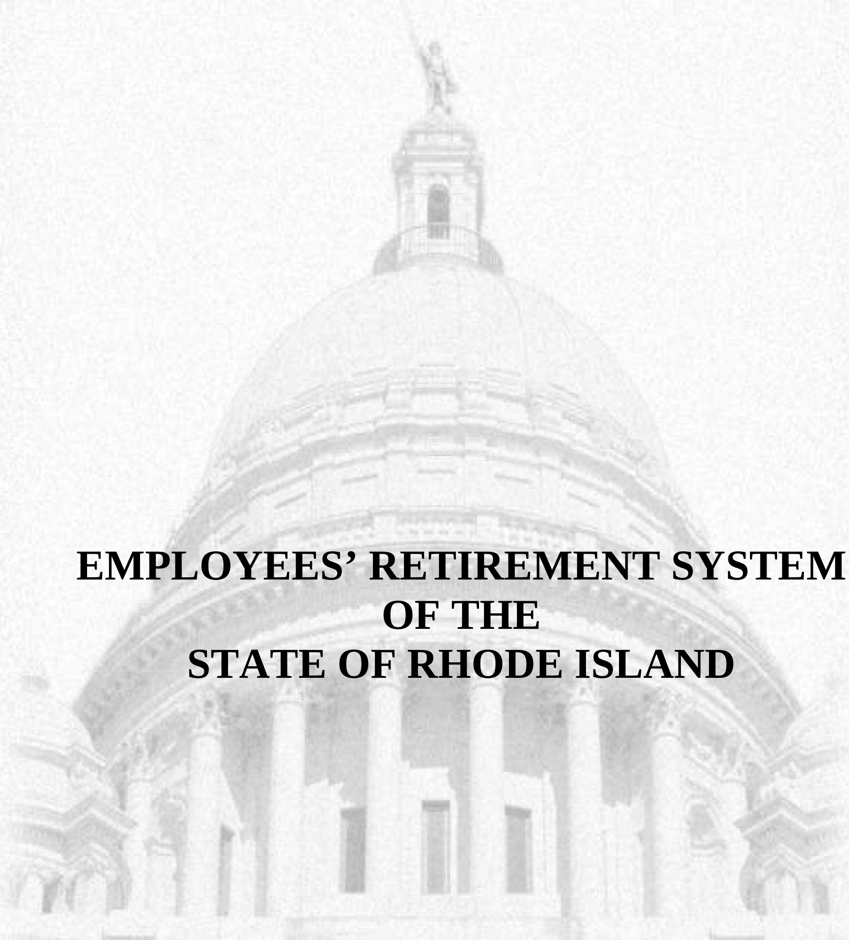
We did, however, note certain other matters that we reported to management of the System in the accompanying Schedule of Findings and Responses.

The System's responses to the findings identified in our audit are included in the accompanying Schedule of Findings and Responses. We did not audit the System's responses and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the members of the Retirement Board, the State Investment Commission, System management, the Joint Committee on Legislative Services, and the House Committee on Finance, 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.

Dennis E. Hoyle, CPA
Auditor General

December 12, 2011



EMPLOYEES' RETIREMENT SYSTEM
OF THE
STATE OF RHODE ISLAND

SCHEDULE OF FINDINGS AND RESPONSES

Management Comment 2011-1

<u>DIVERSIFICATION OF CASH HOLDINGS WITHIN THE POOLED INVESTMENT TRUST</u>

The State Investment Commission (SIC) adopts asset allocation targets for investments held within the Employees' Retirement System. Specific managers have been engaged to invest portions of the investment portfolio consistent with the directives of the SIC and the overall asset allocation targets. All investments are held by the System's custodian bank (State Street Bank and Trust) and most liquid or cash type assets or amounts pending investment are held in an institutional money market fund - State Street Liquid Reserves – Institutional Shares (Liquid Reserves Fund). Within the overall investment portfolio, an amount of cash or highly liquid investments is consistently needed to settle investment trades, meet capital calls on private equity investments, and fund drawdowns to meet the net monthly pension payroll. Such amounts are typically held in the custodian's default investment for cash holdings – the Liquid Reserves Fund.

Due in part to an asset allocation target that designates 2% of the portfolio be held in cash and a near-term anticipated funding of new asset allocation targets (hedge funds), approximately $820 million or 11% of the pooled investment trust portfolio at June 30, 2011 was held in the Liquid Reserves fund. While the underlying holdings within the money market mutual fund are diversified, the System had a very large exposure with one counterparty at June 30, 2011. At September 30, 2011, cash holdings invested in the Liquid Reserves fund had increased to approximately $925 million but more recently decreased to approximately $344 million as of February 2012.

The SIC should consider adopting a diversification policy for cash or cash equivalent investments held within the investment portfolio to mitigate concentration of risk exposure. This could be similar to the short-term investment policy adopted by the SIC for the investment of other funds of the State which requires diversification by investment type and issuer and limits exposure to any one counterparty. This may also include designating a dollar threshold of cash and cash equivalent holdings upon which diversification would be required due to the likely need to keep a minimum amount in the Liquid Reserves fund to settle trades, etc.

<u>RECOMMENDATION</u>

2011-1 Consider adopting an asset diversification policy for cash and cash equivalent type holdings within the pooled investment trust. Such policy may include designating a threshold of cash and cash equivalent holdings upon which diversification would be required.

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

We feel that our cash portfolio is in line with our guideline and manager mandate policies.

While the Cash balance was unusually high for the month ended June 30, 2011 where an overall cash balance of approximately $820 million occurred, we were preparing for the upcoming changes in allocation. As of February 29, 2012 that balance now is $358.6 million or 4.86% of total assets. Of this balance, $110 million was being held for a hedge fund transfer that was made as scheduled on March 1st. This would bring our cash balance to 3.37% of total assets. And of the remaining $249 million in cash, $75 million is tactical cash, which is used for portfolio rebalancing. We are also looking to add a second cash product for diversification. While not a substitute for diversification, but keeping in mind our safety-first philosophy, we would also observe that the highest quality, Liquid Reserve Fund, where our cash resides, tends to hold total invested levels of approximately $25 billion (current level) by its overall investor participants.

Management Comment 2011-2

INVESTMENT RETURN USED TO TRIGGER ANNUAL BENEFIT ADJUSTMENTS

Pension reform legislation enacted on November 18, 2011 provides for conditional cost of living adjustments (COLA) which are triggered by, and based on, the actual performance of the Retirement Systems' assets. As revised, General Law Section 35-10-35(g) provides for a COLA when the "Five Year Average Investment Return" of the system exceeds 5.5% (subject to meeting a designated funded ratio or at five year intervals until such funded ratios are achieved). The "Five Year Average Investment Return shall mean the average of the investment returns of the most recent five (5) plan years as determined by the retirement board".

We believe there could be ambiguity in how this section of the General Laws is interpreted going forward. For example, there are various investment return measures which are frequently made available to the System. These include:

- Annual investment return on the pooled investment trust as reported by the System's investment custodian – this is based on a time weighted average return methodology commonly used by investment professionals. This is reported in aggregate as well as for the various asset allocation subcategories within the portfolio and for the assets managed by a specific manager. These investment returns are typically compared to various benchmarks such as the performance of the S&P 500, Russell 2000 or other market performance measures.

- Annual investment return on the pooled investment trust as reported by the System's investment custodian including any fair value adjustments made for financial reporting purposes. Fair value adjustments are typically made to record those investments of the System which are not traded publicly or have readily determinable fair values – these include private equity and real estate investments. Fair value adjustments are required to present the System's financial statements in accordance with generally accepted accounting principles. These fair value adjustments are not included in the investment return reported by the State's investment custodian.

- Annual return as computed and reported by the System's actuary. This return measure is calculated differently and reflects investment related expenses as well as administrative costs of the System.

- The actuarial return as computed and reported by the System's actuary employs a smoothed-market methodology which reflects investment gains and losses over a five-year period.

For purposes of illustration:

Average investment return for the five years ended June 30, 2010 as reported by the System's investment custodian (arithmetic average)	**3.50%**
Five-year return as of June 30, 2010 and as reported by the investment custodian (for the pooled investment trust)	**2.60%**
Investment return – actuarial – as reported by the actuary in the actuarial valuation performed as of June 30, 2010 for the ERS plan (net of investment and administrative expenses) – represented by the actuary to be the five-year smoothed return as reported for that year	**0.80%**

The actuary also includes other amounts described as average returns – last five years for both market and actuarial as 2.51% and 6.74%, respectively (as included in the June 30, 2010 actuarial valuation).

As demonstrated above, there are various five-year return percentages that could meet the definition as included in the General Laws. Due to the importance of this return percentage in determining whether there is an annual benefit adjustment to the System's members (and the amount of such adjustment), the retirement board should adopt a regulation or policy to clarify and standardize measurement provisions. Alternatively, the General Laws could be amended to clarify the intended specific return which would trigger annual benefit adjustments.

<u>RECOMMENDATION</u>

2011-2 Adopt a policy/regulation defining the determination of the "Five-Year Average Investment Return" consistent with General Law section 35-10-35(g) used for purposes of triggering payment of annual benefit adjustments. Alternatively, seek legislative amendments to clarify the intended specific return amount to be used for this purpose.

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

The statute provides that "(t)he Five-Year Average Investment Return shall mean the average of the investment returns for the most recent five (5) plan years as determined by the retirement board." The statute becomes effective July 1, 2012. ERSRI has consulted with its actuary and the recommendation of the actuary is that the plan use the average five-year actuarial return to be consistent with the calculation of five–year average investment return used for all other purposes of the plan valuation. This recommendation will be made to the Retirement Board and a determination will be made in a timely manner as required by the statute. The other alternatives set forth in Management Comment 2011-2 above would create unnecessary inconsistencies in plan calculations.

Management Comment 2011-3

<u>FAIR VALUE OF ALTERNATIVE INVESTMENTS</u>

Generally accepted accounting principles require that the System's investments be reported at fair value. Alternative investments present unique challenges due to the lack of a readily determinable fair value for these non-publicly traded holdings. Nonetheless, management is responsible for determining such fair value estimates.

The System has adopted certain policies and methodologies to estimate fair values including information provided by its consultants and investment managers. The process begins with audited fair values reported for each alternative investment as of December 31 and then adjusts such values for cash inflows and outflows for the January 1 through June 30. Other significant events or factors occurring in this period are also considered as part of the process.

The System has generally improved its fair value estimation process in recent years but should further enhance controls to ensure adherence to its adopted policies and procedures. For fiscal 2011, management's initial fair value estimates contained incorrect data (information reported in a foreign currency was not converted to US dollars resulting in a $26 million understatement). In addition, cash inflows and outflows included amounts (certain capital gains and distributions) that should have been excluded in accordance with Treasury policy. Supervisory/management review could be enhanced to ensure proper classification of key investment transaction data used in estimating fair values is consistent with its adopted policies.

RECOMMENDATION

2011-3 Ensure data used in the determination of fair values for alternative investments is consistent with adopted policies. Enhance supervisory/management review of the fair value estimation process.

Auditee Views and Corrective Action Plan:

Our process has been enhanced greatly over the past two years. Acknowledging that the valuation of Alternative investments is challenging throughout the industry, due to the nature of the product and the fact that audited information is from the preceding December, we have placed a high priority on providing the best possible data for valuations. For FY2011, we provided the auditors, upon their request, the data prior to the final check and balance. During FY2011, we hired a new Private Equity consultant, and they did not provide the yearend report as timely as the prior consultant. A specific staff person assigned, after the audit was completed, has been working on this issue, and we have held meetings with the consultant and custodian to solidify and further enhance our evaluation process.

Management Comment 2011-4

INACCURATE 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 identified a population of 19,135 active members as of June 30, 2010 that were hired before the ANCHOR system was operational. We selected a statistical sample of 48 members from this population and found that the service credit data in ANCHOR for 5 (or 10.4%) of the 48 members was inaccurate. The specific errors in these 5 files are outlined below.

Member	Service Credits Recorded in Anchor	Actual Service Credits	Variance (Years of Service)	Potential Cause
1	24.00	22.00	2	Break in service, refund of contributions and subsequent buy-back.
2	12.50	11.50	1	Half-time teacher for a few years.
3	25.69	25.44	.25	Member switched from MERS plan to ERS.
4	19.50	19.75	(.25)	Half-time teacher switched to full-time.
5	25.75	25.25	.5	Teacher -- did not always work enough days to obtain a full year's service credit.

ERSRI's estimate of service credits recorded in the ANCHOR system was 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.

The results of our statistical sample indicate it is likely that there are errors in the amount of service credits for approximately 1,990 members (population of 19,135 X 10.4% error rate). ERSRI should complete the process of identifying the member accounts that have errors and adjust the amount of service credits recorded in ANCHOR. In the meantime, ERSRI should work with its actuary to develop some means to make appropriate adjustments to the upcoming valuations in an attempt to more accurately reflect service credit data.

RECOMMENDATION

2011-4 Develop a plan to review member records to ensure all member accounts have accurate service credit data. Ensure that the System's actuary makes appropriate adjustments to account for inaccurate service credit data when developing plan valuations.

Auditee Views and Corrective Action Plan:

ERSRI is and will continue to increase its efforts to validate accounts and will evaluate additional resources to perform data validations. In addition, ERSRI has requested that the System's actuary review these service credit variances and make adjustments to the actuarial valuations when applicable.

The matter being referenced relates to member service credit and to the original data conversion to the ANCHOR system in 2001. As was noted, 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 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.

Management Comment 2011-5

RECONCILE AND RESOLVE GENERAL LEDGER BALANCES

We observed balances in the System's general ledger which require investigation and resolution to ensure (1) such balances are appropriately reflected on the System's financial statements and (2) controls are adequate and the ANCHOR system is functioning as intended.

Benefit Overpayment Receivables

Benefit overpayments can occur as part of the normal pension payment process. For example, retirees may occasionally be paid an estimate of their benefit payment until sufficient information can be collected to calculate the actual benefit due. In some cases, the estimated payments exceed the actual benefit that is due resulting in a net overpayment. Overpayments can also occur due to other situations such as when a benefit continues to be paid after the death of a member who had not chosen one of the beneficiary options. Once the overpayments are identified, the System creates a receivable and commences the process to recover the overpayment.

At June 30, 2011, the benefit overpayment receivable account totaled $601,701. The System could not provide a detailed breakdown of the various components of this balance. In addition, it does not periodically review these accounts to assess the likelihood of collectability. We found that one of the overpayment receivable accounts totaling $119,358 was created in fiscal 2004 and there has been no activity in the account since that time.

RECOMMENDATION

2011-5a Review the Benefit Overpayment Receivable accounts to assess the likelihood of collectability and write off any amounts deemed uncollectible.

Retiree Health Care Withholding

The System maintains a "clearing" account to account for the amounts withheld from retirees' pension payments for their share of their health care premiums. The account is intended to simply record the initial withholding and subsequent payment to the state to pay for the cost of health care claims processing. As a result, the account should show either a liability (credit balance) or a zero balance. The health care withholding account, however, had a debit balance of $624,953 at June 30, 2011. The System was unable to explain the reason for this balance.

RECOMMENDATION

2011-5b Investigate activity in the Retiree Health Care Withholding account and make appropriate adjustments accordingly.

Contributions Payable

The System maintains another liability account entitled "contributions payable" which had an unexplained debit balance of approximately $667,132 at June 30, 2011. The debit balance is inconsistent with the normal activity expected in a liability account.

RECOMMENDATION

2011-5c Investigate activity in the contributions payable account and make appropriate adjustments accordingly.

Auditee Views and Corrective Action Plan:

2011-5a

The line of business system does have reporting capabilities for producing the receivables owed to the System. The System will enhance the procedure and continue to review the accounts and determine the collectability. A receivable would be created due to the timing of when the death of a member and/or beneficiary is reported to the System. The receivable would be recorded when the member/beneficiary is not entitled to receive a payment. The System utilizes an outside service to track the death of members/beneficiaries on a monthly basis. In addition, a death benefit that is owed to a member/beneficiary is not paid until any outstanding receivables have been satisfied. ERSRI will work to improve financial reporting of these types of receivables.

2011-5b

ERSRI determined that the account is a clearing account. However, balances may exist in these accounts due to timing differences. In this particular case the appropriate offset for the transactions were being posted into another general ledger account. The System will make the necessary adjustments.

2011-5c

When the accounts were reviewed for reporting purposes it was determined that it was not necessary for the System to make any adjusting entries.

Management Comment 2011-6

MEMBERSHIP APPLICATIONS

The System should consider revising its current policy which requires each new member to independently submit a membership application. We believe there are multiple advantages to requiring employers to submit membership applications on behalf of new hires. These advantages are summarized below:

- ERSRI's member database would be complete immediately as new members begin to make contributions.

- Eligibility for membership in the System's plans would be determined at the time of hiring. In a prior audit, we found 17 state employees who were not contributing to the ERS plan but were required by statute to participate. We believe completion of a membership application (or a determination of ineligibility) by both the employee and employer at the time of hire would strengthen controls over this process and provide documentation of those determined to be both eligible and ineligible for participation.

- Members who have not submitted membership applications fail to designate a beneficiary for their contributions and death benefit.

RECOMMENDATION

2011-6 Modify the membership application process to require participating employers to submit member applications upon hiring a new employee. Consider alternate on-line membership application options.

Auditee Views and Corrective Action Plan:

ERSRI will review and consider the programmatic and procedural costs associated with providing an on-line application process.

ERSRI's current practice for receiving member applications is based on the initial receipt of member contributions by the employer. ERSRI's experience suggests there is limited, if any, correlation between determining membership eligibility and the delivery of membership applications. Such determinations of employment status (i.e., part-time, seasonal, full-time etc.) are made prior to the official offer and acceptance of employment, membership applications are not the determinate. Additionally, completion of the application does not always ensure receipt *of contributions. Experience has proven applications are received but due to a myriad of budgetary issues, positions may no longer have anticipated funding and thus no FTE is created.*

ERSRI has strengthened its vigilance in securing completed applications and beneficiary information from members and employers by developing an internal report that list members who made contributions into the system but do not have an application on file. The reports are generated at the end of the month and are sent to the local employers to contact those members and instruct them to provide ERSRI with a completed application and beneficiary nomination form.

Management Comment 2011-7

CONTRIBUTIONS OWED THE SYSTEM

We reported a finding (Finding 2009-3 in the Fiscal 2009 Single Audit Report) relating to a weakness in the State's payroll system over coding for retirement plan participation. Due to the coding errors, we found that certain state employees were not contributing to the Employees' Retirement System of Rhode Island (System). Various corrective actions were taken by the Office of Accounts and Control to (1) eliminate the control weakness that allowed the situation to occur and (2) retroactively ensure all state employees that are required to be members of ERSRI are coded appropriately within the payroll system thereby ensuring required employee and employer contributions are made.

Seventeen employees were identified as owing contributions to the System based on the above noted situation. The System sent notices to the employees during Fiscal 2010 advising them of the amount owed as well as their options for payment (lump sum or through payroll withholding over not more than 5 years). At the conclusion of our audit of the financial statements of ERSRI for the year ended June 30, 2011 only one employee had paid the amount owed or entered into a payment agreement. The State's (employer) contribution has only been remitted for the one employee who paid their employee share. The amount owed as of June 30, 2011, not including interest, was estimated at $345,000 (employee and employer share).

While the amount owed is not material relative to the assets of the System, the amounts owed by some employees are significant and growing due to accruing interest. We recommend that these balances be collected immediately, including the State's (employer) share of contributions along with accrued interest.

There are various options that could be pursued to collect these balances and we believe that the System should work with the Office of Accounts and Control to find a solution that best balances avoidance of any unintended hardship on the employees with the System's fiduciary responsibility to collect all contributions due.

RECOMMENDATION

2011-7 Collect balances owed the System from members who were not contributing as State employees and the related employer share. Work cooperatively with the Office of Accounts and Control to resolve and collect the amounts owed including employer contributions and related interest as applicable.

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

ERSRI has been in contact with the Office of Accounts and Control and has issued an official communication to the department instructing them on the System's position. The System will attempt to collect the contributions that are due as prescribed in Rhode Island General Law.

Management Comment 2011-8

<u>CONSIDER UTILIZING THE STATE RIFANS ACCOUNTING SYSTEM FOR THE GENERAL LEDGER COMPONENT OF THE SYSTEM'S LINE OF BUSINESS SYSTEM</u>

The System is currently reviewing proposals for a replacement to its current line of business system (ANCHOR and PeopleSoft G/L). The State's statewide accounting system (RIFANS – Oracle General Ledger) includes general ledger functionality that should be considered to meet that aspect of the System's overall system requirements. This may meet the need at a lower cost and is consistent with the State's goal of having an overall statewide accounting system. The State's newly created OPEB system, which has similar trust fund accounting aspects, was recently established within RIFANS.

<u>RECOMMENDATION</u>

2011-8 Consider utilizing RIFANS (the State's centralized accounting system) to meet the general ledger component of the System's replacement line of business system presently under proposal.

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

The System is currently evaluating proposals from vendors for a new line of business system. Included in this evaluation process the System is considering an upgrade to a new general ledger accounting system. The System is seeking a general ledger package that is going to be synergistic with the new line of business system. The System will select a general ledger package that will its meets needs and be in line with the goals/mission of ERSRI.

Management Comment 2011-9

<u>IMPROVE CASH RECONCILIATION EFFICIENCY - ELECTRONIC BANK RECONCILIATIONS</u>

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. This functionality should be sought as the System pursues a new computer system including a new general ledger component.

<u>RECOMMENDATION</u>

2011-9 Explore options to increase automation of the reconciliation process with the System's financial institutions by seeking electronic bank reconciliation functionality within the procurement of new general ledger package.

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

The System is currently evaluating proposals from vendors for a new line of business system and general ledger package. Included in this evaluation process the System has requested that the new line of business system and the general ledger package have the capability of performing electronic bank reconciliations. In addition, the System must consider this functionality's effect on the current organizational structure of ERSRI and the Treasury.

Management Comment 2011-10

<u>IMPROVE CONTROLS OVER THE RELIABILITY OF CONTRIBUTIONS RECEIVABLE FOR FINANCIAL REPORTING PURPOSES</u>

Contributions from both employees and employers are recognized as revenue (additions) based on employer payroll activity – contributions are considered receivable when wages are paid to the employee. For financial reporting purposes, contributions receivable at June 30 are derived from (1) the ANCHOR wage and contribution system based on actual contributions submitted, without cash remittance to the system prior to the end of the fiscal year, and (2) an analysis performed to calculate contributions receivable based upon actual contribution data received after the end of the fiscal year relating to payroll periods prior to the end of the fiscal year.

The year-end analysis of contributions receivable can be improved to provide a higher level of assurance that the contributions receivable balances are accurately recorded. Our audit procedures in prior years found several instances where one or more of the contributions receivable balances were misstated.

Our 2011 audit found another instance where the receivable balances (and related revenue) were misstated – both were overstated by $847,000. Specifically, the System performs an analysis at year-end to calculate the amount it should accrue for employee and employer contributions due but paid after fiscal year end. Due to a programming error in the query used in the 2011 analysis, the System accrued for contributions received and posted into the ANCHOR wage and contribution system on June 30 (essentially on the last day of the fiscal year), thereby double-counting these contributions.

The System should adopt certain control procedures that would help prevent or detect misstatements in the contributions receivable balances. This should include a written policy describing standard close-out procedures. This policy should require specific analytical procedures that would aid in determining whether or not the receivables balances are complete in all material respects.

<u>RECOMMENDATIONS</u>

2011-10a Revise the query used to analyze contributions for accrual purposes to include only those wage and contributions data that are received after year-end.

2011-10b Implement control procedures over the manual processes used to calculate contributions receivable at fiscal year-end for financial reporting purposes.

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

ERSRI will review and make the necessary revisions to the query to include only those wage and contributions data that are received after year-end. In addition, ERSRI will develop additional procedures to continue to improve financial reporting of contributions receivable.

The System has over 190 participating member units that submit wage and contribution data into the ANCHOR system on various payroll frequencies. The process for analyzing contributions receivable is reviewed by the accounting department. Currently, ERSRI is seeking to procure a new accounting system in addition to an updated line-of-business system in which it will develop enhanced capability for computing, recording, and tracking accounts receivable.

Management Comment 2011-11

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 ERS plan's pension benefit payroll.

RECOMMENDATIONS

2011-11a Require member units to remit contributions to the System electronically rather than by check.

2011-11b 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 replacement business system will contemplate the electronic remittance of contributions.

Management Comment 2011-12

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. Oftentimes, precedent and past practices are used to guide various administrative decisions. For example, some of these topics may 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; and
- Actuarial reductions taken in computing amounts paid to a beneficiary when a member dies in service.

We believe ERSRI should undertake a process to promulgate and codify various policies which have been informally developed.

<u>RECOMMENDATION</u>

2011-12 Promulgate and codify various informal policies used in the administration of the System.

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

ERSRI regularly publishes regulations that are approved and promulgated by the Board. ERSRI has updated regulations and members' handbooks to support current business needs. 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 2011-13

<u>REVISE THE TIME FRAME FOR SUBMITTING THE SYSTEM'S ANNUAL REPORT</u>

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 System's annual report is required to include a variety of information including financial statements and actuarial data. The System has interpreted the statute to require actuarial data as of the same date as the financial statements although the availability of the actuarial valuation lags the audited financial statements. Actuarial data included in the audited financial statements is typically as of a date one year prior to the balance sheet date. Consequently, the annual report, when issued approximately one year after the audited financial statements are available, includes actuarial data that was not available when the financial statements were prepared or audited. This gives the impression that the financial statements and related disclosures are misstated.

We suggest that the section of the General Laws (36-8-8) regarding the annual report and statement be reviewed and updated to reflect a more current view towards the timeliness of financial data. Additionally, the annual report, if required more timely, should include actuarial information consistent with actuarial data included in the financial statements. Further, there are numerous items listed in the law which are not included in the System's annual report.

RECOMMENDATION

2011-13 Propose revision to the section of the General Laws which requires the System to provide an annual report. Revise the time frame for submission and the required annual report components.

Auditee Views and Corrective Action Plan:

The recently enacted regulation changes due to RIRSA will help align the reporting periods of the report's components. Also, the timing of the production of the pension fund's valuation will be 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.

Management Comment 2011-14

INFORMATION TECHNOLOGY GOVERNANCE AND STRATEGIC PLAN

ERSRI can enhance oversight of its Information Technology (IT) systems through development of an Information Technology Governance and Strategic Plan. Although most IT responsibilities have been outsourced, such a plan could ensure that security, operational documentation, program change controls, user access rights, and equipment issues have been adequately addressed and continually monitored. For example, the plan could outline required monitoring of the consultant's reports on system changes, data element changes, and user access rights – and ensure that the functioning/processing performed by the consultant complies with contract provisions.

A comprehensive Information Technology Governance and Strategic Plan would also be useful as ERSRI moves forward with the procurement of an upgrade or replacement for its ANCHOR and general ledger applications and is defining responsibilities to be performed by a contractor.

RECOMMENDATION

2011-14 Develop and implement an IT Governance and Strategic Plan.

Auditee Views and Corrective Action Plan:

During FY2012, the System has been developing a comprehensive Information Technology Governance and Strategic Plan. The plan will be designed to identify the IT investment priorities for the System. The Plan will also be used to identify and document the initiatives that the System has for its technology infrastructure to provide the required management and services to meet the System's mission

ERSRI's senior management meets regularly with the IT consultants to ensure issues indicated above are being addressed. In addition, the service level agreement with the IT consultant addresses specific responsibilities of the vendor and the items mentioned in the finding. Due to ERSRI's anticipated ANCHOR system upgrade, it has been addressing such issues with its IT Systems Consultant and will translate such plans into the updated system.

Management Comment 2011-15

EXPAND IN-HOUSE INFORMATION TECHNOLOGY RESOURCES

ERSRI's computer system was developed by a contract vendor and continues to be supported by the same vendor. The vendor is contracted to operate the on-site data center and essentially is responsible for all operations of ERSRI's IT systems.

While it would be impractical for ERSRI to assume these responsibilities with existing or additional employees, ERSRI should consider adding an additional in-house IT staff person to oversee the responsibilities of the contractor, be responsible for security administration, and build institutional knowledge of the system to potentially reduce reliance on the contractor in the future. This individual could provide the needed "in-house" guidance, assistance and oversight regarding the current and future technical issues facing ERSRI's expanding IT systems.

Additional IT staff may also be warranted as ERSRI procures a significant upgrade to its system necessitated by software used in the ANCHOR system that is no longer supported by the software vendor. The upgrade will likely be a significant project in terms of time and funding and will require project management resources. Without adding IT resources, project management would fall to existing staff, and likely negatively impact performance of their current duties or also need to be outsourced.

RECOMMENDATION

2011-15 Consider adding an information technology staff member to oversee the system responsibilities performed by the contracted IT vendor and to provide the needed "in-house" guidance, assistance and oversight regarding the current and future technical issues facing ERSRI's expanding IT systems.

Auditee Views and Corrective Action Plan:

Given the anticipated upgrade to the ANCHOR system, ERSRI will consider necessary IT staffing while also considering the budget constraints.

Management Comment 2011-16

LOG CHANGES TO CRITICAL DATA ELEMENTS WITHIN THE ANCHOR SYSTEM

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 or events. ANCHOR maintains "history" tables; however, there is no automated method to extract and report upon any changes made to critical individual data elements or application system events.

It is critical that management know if any changes (authorized and unauthorized) to retirement contribution or benefit data and/or the application system have been made since it could have a direct impact on future benefits paid to members.

ERSRI management should consider acquiring a third-party audit software to report on data elements that have been changed. A number of vendors offer packages that are designed to selectively capture and report upon user selected "auditable" data elements. The "audit package" is designed as an add-on application that works in conjunction with the ANCHOR system and therefore requires no additional programming be performed within the user application. This feature should also be incorporated within any future modification to the current system or replacement system and would be another area where the addition of an IT staff member would be instrumental in selection of a package and review of output from the package.

RECOMMENDATION

2011-16 Enhance control over changes to critical data elements within the current ANCHOR system by acquiring third-party audit software that can track and report on changed data elements.

Auditee Views and Corrective Action Plan:

ERSRI has made this a requirement in its ANCHOR system upgrade and will seek to determine the selected vendors' choice of the third-party software suggested by the OAG.

Management Comment 2011-17

ENHANCE MONITORING OF THE CONSULTANT CHANGE MANAGEMENT PROCESS

ERSRI does have a method of documenting and tracking changes made to the ANCHOR application system. However, this process was not in effect for FY 2011 and ERSRI did not have sufficient documentation of changes made to the system. Although the new process will enable ERSRI management track their initiated change requests, they do not receive or review on a periodic basis any change reports or logs to verify that only approved/authorized changes have been made to the system. In addition, ERSRI relies on the documentation contained within their vendors change management system to evidence changes that were made to the ANCHOR application system.

ERSRI management must have a clear understanding and proper documentation of what change(s) are made to the ANCHOR system and that those changes properly address management's concerns and work as intended. This is critically important as a significant number of statutory benefit changes are programmed into the ANCHOR system. Furthermore, management should monitor on a periodic basis that only authorized changes are being made to the system and not rely solely on the vendor to review and control changes. Although this could be dealt with contractually, it still does not eliminate the risk of unauthorized changes being made due to the access rights granted vendor personnel to the system and its data.

RECOMMENDATION

2011-17 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 will examine additional change management procedures as part of IT Governance and Strategic Plan. The System maintains Change Control Request documentation when implementing major programmatic changes such as the legislative changes required by recently enacted pension reforms.

ERSRI meets with senior members of the IT Outsource Team on a regular basis to discuss/review changes which may be required to the ANCHOR system. Expected results are discussed, then coded and deployed to the test environment to be tested by applicable ERSRI staff. Upon successful confirmation from staff on the results of testing, the IT Outsource team communicates the items to be deployed to production and awaits approval from ERSRI's management.

Management Comment Communicated Confidentially 2011-18

As permitted by General Law section 22-13-10, *Audit of Information Security Systems*, we have communicated a finding confidentially that relates to security over ERSRI's computer systems.