
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, 2007

Ernest A. Almonte, CPA, CFE
Auditor General

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



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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS
GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

- ◆ INTEGRITY
- ◆ RELIABILITY
- ◆ INDEPENDENCE
- ◆ ACCOUNTABILITY

March 7, 2008

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER William J. Murphy, Chairman

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

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, 2007 and have issued our report thereon dated January 8, 2008. 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, 2007*.

In accordance with *Government Auditing Standards*, we have also prepared a report, dated January 8, 2008 and 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. Our report on the System's internal control over financial reporting and on compliance and other matters indicated certain issues that we considered to be significant deficiencies in internal control over financial reporting. These control deficiencies are described in the accompanying Schedule of Findings and Responses.

We also 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,

Ernest A. Almonte, CPA, CFE
Auditor General

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

FISCAL YEAR ENDED JUNE 30, 2007

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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, 2007 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated January 8, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that misstatement of the entity's financial statements that is more than inconsequential will not be prevented

or detected by the entity's internal control. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as Findings 2007-1 and 2007-2 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all the deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

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

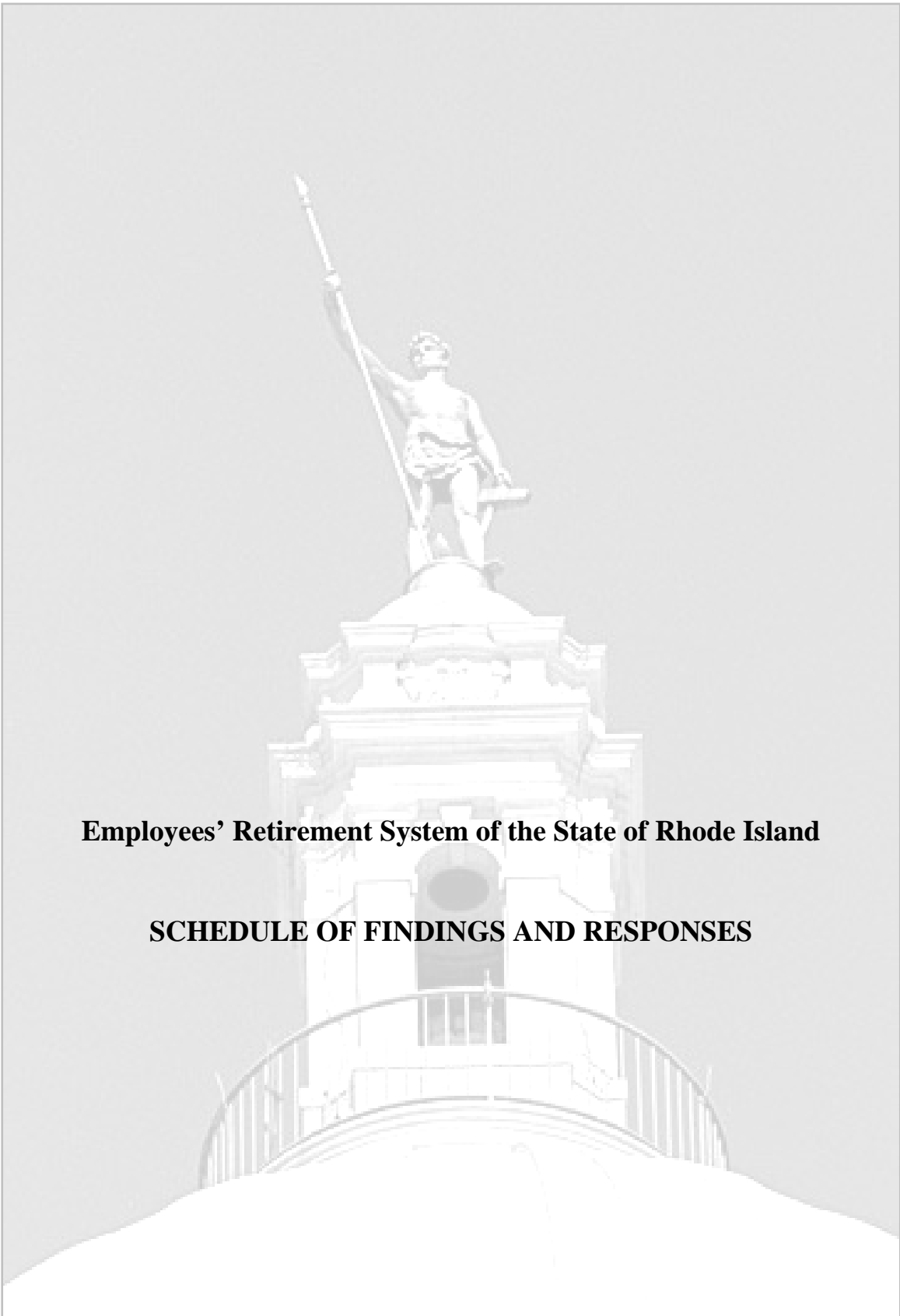
The System's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. We did not audit the System's responses and, accordingly, we express no opinion on it.

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



Ernest A. Almonte, CPA, CFE
Auditor General

January 8, 2008



Employees' Retirement System of the State of Rhode Island

SCHEDULE OF FINDINGS AND RESPONSES

SIGNIFICANT DEFICIENCIES

FINDING 2007-1

IMPROVE MONITORING CONTROLS OVER SYSTEM INVESTMENTS AND ENHANCE INFORMATION REQUIRED FOR FINANCIAL REPORTING

Responsibility for certain aspects of financial reporting relating to investments should be better coordinated to improve the timeliness, completeness, and quality of the data generated as well as controls over its accumulation. Monitoring of the investment portfolio can also be enhanced to ensure timely and effective oversight of the System's diversified investments.

The growth and complexity of the System's investment portfolio warrant additional attention to the accounting and financial reporting aspects of the investment cycle. Additionally, complex investment valuation issues, disclosure of investment-related risks, the System's exposure to derivative type investments, the overall requirements of preparing financial statements in accordance with generally accepted accounting principles and the need to monitor the activities of various parties involved with the System's investment portfolio have increased the need for accounting resources. Accounting responsibility for the System's investments is fragmented since a Treasury unit separate from the Retirement Division is responsible for the investment activity cycle.

The following areas should be addressed in improving controls over financial reporting as it relates to the System's investment cycle.

- The nature and volume of the data required for financial statement preparation and note disclosure necessitates attention throughout the fiscal year rather than just once a year as part of preparing annual financial statements. Subsequent to June 30, 2007, Treasury reassigned an individual to supplement staff assigned to investment monitoring. Specific training and task assignment need to continue through the next financial reporting cycle to ensure the newly allocated resources meet the anticipated objective.
- Investment transactions are recorded, reported, and summarized by ERSRI's investment custodian. Recording and reconciling this activity (in summary form) within the System's accounting records is performed only once at the close of the fiscal year. Summarized investment activity reported by the custodian should be analyzed and reconciled monthly to detect variances and mispostings on a timely basis. Variances often occur in the recording of transfers to and from the plans. These variances need to be corrected promptly because of the impact on the allocation of assets among the System's four plans. Errors may also occur in the recording of other investment transactions which require correction. For example, during fiscal 2007 the custodian misposted activity for two private equity investments with similar partnership names. Total assets were not misreported but the balances for the specific investments were materially misstated – upon sale or dissolution of the investment, the gain or loss would

have been similarly misstated. Enhanced review of the monthly reports provided by the investment custodian with monthly recording of the summarized activity within the System's general ledger will highlight any variances on a timely basis and allow prompt correction by the System's investment custodian as required and improve controls over financial reporting.

- Coordination between the Retirement and Treasury-Finance Divisions can be enhanced to meet the objective of preparing timely financial statements in accordance with generally accepted accounting principles (GAAP). The process of accumulating all the required investment information necessary to prepare financial statements should be coordinated by individuals knowledgeable about financial reporting and governmental GAAP. This process should be lead and coordinated by the Retirement Division. Specific year-end closing tasks should be assigned and data to be requested from various external parties should be formalized and scheduled. Areas that require additional attention include the reporting and disclosure of derivative type investments, the classification of investments by various risk categories, and the fair value estimation process for investments that are not publicly traded.
- An overall investment monitoring plan should be formalized to ensure appropriate and timely oversight of the System's diversified investments. The System's investments are appropriately diversified with many advisors, managers, consultants, and investment custodians involved in the overall administration of the investment portfolio. Each of these parties has a specific role to perform with Treasury assuming ultimate oversight and monitoring responsibility. We found that monitoring could be improved in a number of areas including (1) securities lending to ensure that the System receives its appropriate share of income, (2) service auditor reports ("SAS 70 reports") of the investment custodian's internal control structure, and (3) documentation of the review and resolution of investment manager compliance exceptions reported by the investment custodian's compliance monitoring system. A detailed monitoring plan which delineates each investment category, the various parties and their respective roles, the frequency of the monitoring activity and the Treasury personnel responsible for the monitoring activity should be formalized.

RECOMMENDATIONS

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| 2007-1a | Continue training and developing specific task assignments for individuals involved with investment monitoring to ensure the additional resources committed to these activities achieve the intended objective. |
| 2007-1b | Analyze and reconcile investment activity reported by the custodian monthly to detect variances and mispostings on a timely basis. |
| 2007-1c | Enhance coordination between the Retirement and Treasury-Finance Divisions to meet the shared objective of preparing financial statements in accordance with generally accepted accounting principles. This process should be lead by the Retirement Division. |

2007-1d Formalize an overall investment monitoring plan which delineates each investment category, the various external parties and their respective roles, the frequency of the monitoring activity and the Treasury personnel responsible for the monitoring activity.

Auditee Views:

2007-1a *Treasury-Finance concurs with the recommendation, and has initiated several new procedures, as well as a new position in order to enhance overall monitoring of the portfolios.*

2007-1b *Treasury-Finance agrees with the recommendation, and has designated the monthly responsibilities to the aforementioned “new position”.*

2007-1c *Treasury-Finance is in the process of initiating several new procedures in order to better coordinate efforts with ERSRI. Once again the addition of the new position, we believe, will address any concerns with this finding.*

2007-1d *Treasury-Finance has formal monitoring processes across all investment categories. Treasury-Finance will continue to enhance the existing processes.*

FINDING 2007-2

IMPROVE THE RELIABILITY OF CONTRIBUTIONS RECEIVABLE REPORTED BY THE ANCHOR SYSTEM

Contributions from both employees and employers are recognized as revenue (additions) based upon employer payroll activity – contributions are considered receivable when wages are paid to the employee. When employers report their detail contribution data before remitting payment to the System, ANCHOR appropriately recognizes contributions receivable. Without actual detail contribution data, the ANCHOR system has not generated reliable estimates of contributions due the System for financial statement reporting purposes. With the intent of improving information available for financial reporting, ERSRI required all participating employers to report their detail contribution data for fiscal 2007 payrolls on a timely basis. This improved the reporting of contributions due the system at June 30, 2007 but contributions and contributions receivable reported by ANCHOR still required analysis and adjustment to yield amounts that are appropriate for financial statements prepared in accordance with generally accepted accounting principles.

Some of the balances reported by ANCHOR for an employer are inaccurate because of posting errors that occurred in prior periods. While a modification was made to the system which allows correction of posting errors on a prospective basis, previously known errors have

been tracked off-line and therefore the ANCHOR system may not report accurate current balances of contributions receivable for a specific unit. Additionally, the ANCHOR system is intended to be self-monitoring by employers, allowing them access to the system via the internet to assess the status of contribution data and remittance of payments. Inaccurate employer contribution receivable data limits the effectiveness of this system function.

The analysis and correction of misposted contribution data has been ongoing since the ANCHOR system was implemented in fiscal 2002. The analysis and adjustment of member unit contribution receivable data must be completed expeditiously to improve controls over financial reporting.

Other issues which impact the reliability of contributions receivable reported by ANCHOR stem from certain system configurations that were designed to ensure the integrity of employer wage data uploaded to the ANCHOR system but are inconsistent with financial reporting objectives. For example, employer wage data is only posted to the system if there is a match of 95% or more of the items reported – if the test is not met the data is held in suspense until corrected or resolved. Amounts due from the State as the matching share of employer contributions for teachers are only billed once 100% of the employer reported data has been successfully posted. Analyses have been developed to work around these system configurations; however, controls over financial reporting are impacted. ERSRI is considering modifying some of these system configurations now that the integrity and accuracy of data reported by employers is less of an issue than when the ANCHOR system was first implemented.

RECOMMENDATIONS

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| 2007-2a | Complete analysis and reconciliation of prior period posting errors affecting contributions and contributions receivable by employer unit. |
| 2007-2b | Review and modify existing ANCHOR system configurations to improve the reliability of contribution receivable data reported by the ANCHOR system. |

Auditee Views:

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|---------|---|
| 2007-2a | <i>ERSRI will continue with the reconciliation of prior period posting errors and anticipates completion of this project by the close of calendar year 2008.</i> |
| 2007-2b | <i>ERSRI concurs with the finding and will work to develop strategies that will improve the financial reporting of contributions receivable. ERSRI anticipates modifying the contribution posting configurations to require 100% postings, thereby mitigating impacts on controls over financial reporting.</i> |

OTHER FINDINGS AND RECOMMENDATIONS

FINDING 2007-3

CONSIDER 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 consider requiring electronic remittance of employer contributions to speed the availability of those contributions to the System 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.

RECOMMENDATION

2007-3 Consider requiring member units to remit contributions to the System electronically rather than by check.

Auditee Views:

ERSRI has considered this approach in the past. Currently, ERSRI has over 190 different employers that post and make payments to ERSRI on a payroll frequency basis. ERSRI will again examine the employer coordination, programmatic and legislative efforts involved and make appropriate determinations.

FINDING 2007-4

COMPLETE DEVELOPMENT OF AN ACCOUNTING MANUAL

ERSRI began development of an accounting manual to formalize its accounting policies and procedures and to structure its annual closing and financial statement preparation process. While progress has been made, the manual is not complete and requires additional data to serve as a resource for the System's accounting staff. An internal workgroup should be formed to complete development of the accounting manual.

RECOMMENDATION

2007-4 Complete development of an ERSRI accounting manual.

Auditee Views:

ERSRI concurs with recommendation 2007-4.

FINDING 2007-5

IMPLEMENT INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES

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

ERSRI recently had a vendor perform a risk analysis/vulnerability assessment of its computer system which included the development of draft information system security policies and procedures. ERSRI needs to now review and finalize the system security policies and procedures and then formally communicate them to its employees, the System's information technology contractor, and other users of ERSRI's computer system. Implementation of the system security policies and procedures should include training to achieve the appropriate level of awareness of the new policies and procedures.

These policies and procedures must be periodically updated. At a minimum, the information systems security plan should be reviewed on a scheduled basis or as required by major modifications in operations, computer hardware, or software. Responsibility for updating and maintaining the policies and procedures should also be assigned.

RECOMMENDATION

2007-5 Implement comprehensive information systems security policies and procedures.

Auditee Views:

ERSRI concurs with this recommendation. ERSRI anticipates the security policies will be implemented by the end of calendar year 2008. ERSRI has also adopted policies that will provide for follow up reviews bi-annually to ensure security procedures and policies are current.

FINDING 2007-6

CONSIDER EXPANDING 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. The vendor was paid approximately \$828,000 for fiscal 2007 system support services.

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 contemplates a significant upgrade to its system necessitated by software used in the ANCHOR system that will no longer be 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

2007-6 Consider adding an additional 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:

Although ERSRI has not been presented with any formal analysis in support of "in-house" information technology resources versus contracted services, ERSRI's Procurement Subcommittee has recently raised the need for a consultant to review the current ANCHOR application to determine any applicable upgrades. As part of the review, the matter of system maintenance and resources will be analyzed.

FINDING 2007-7

COMPLETE DEVELOPMENT OF A COMPREHENSIVE DISASTER RECOVERY/ BUSINESS CONTINUITY PLAN

ERSRI's recent risk analysis/vulnerability assessment of its computer system by a vendor highlighted the need for a comprehensive disaster recovery/business continuity plan to cover all aspects of ERSRI's operations. Certain disaster recovery plan components are the responsibility of ERSRI's IT contractor; however, the aspects regarding recovery of key computer systems needs to be integrated into an overall business continuity plan to be developed by ERSRI.

The comprehensive disaster recovery/business continuity plan must detail how ERSRI would recover its critical service delivery capabilities. For example, it must contain detail pertaining to new facilities and workspace, office equipment, voice and data connectivity, additional temporary staff and required on-site technical expertise.

ERSRI operations need to be reviewed and analyzed to document all that would be considered agency critical systems and services, determining the maximum amount of time that the agency could operate without those critical systems. Alternative delivery methods should be developed to ensure that the minimum required services (e.g., continuation of pension benefits) provided by these critical systems reach the intended recipients.

RECOMMENDATION

2007-7 Complete development of a comprehensive disaster recovery/business continuity plan for ERSRI.

Auditee Views:

ERSRI has a documented disaster recovery plan, prepared by the system vendor, in place to ensure the recovery of the computer hardware and Anchor application system in the event of a catastrophic event. ERSRI concurs with this finding and will continue to develop a plan that is more comprehensive and will adequately address the aforementioned issues.