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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, 2012**

Dennis E. Hoyle, CPA  
Auditor General

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

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# Office of the Auditor General

State of Rhode Island and Providence Plantations - General Assembly  
Dennis E. Hoyle, CPA - Auditor General

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May 7, 2013

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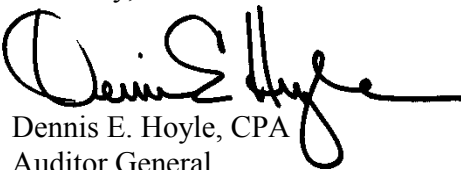
Representative Brian C. Newberry

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, 2012 and have issued our report thereon dated December 3, 2012. 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, 2012*.

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

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND**

FISCAL YEAR ENDED JUNE 30, 2012

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# Office of the Auditor General

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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, 2012 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated December 3, 2012. 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 first paragraph of this section 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 previously.

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

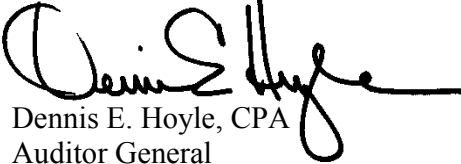
Compliance and Other Matters

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*.

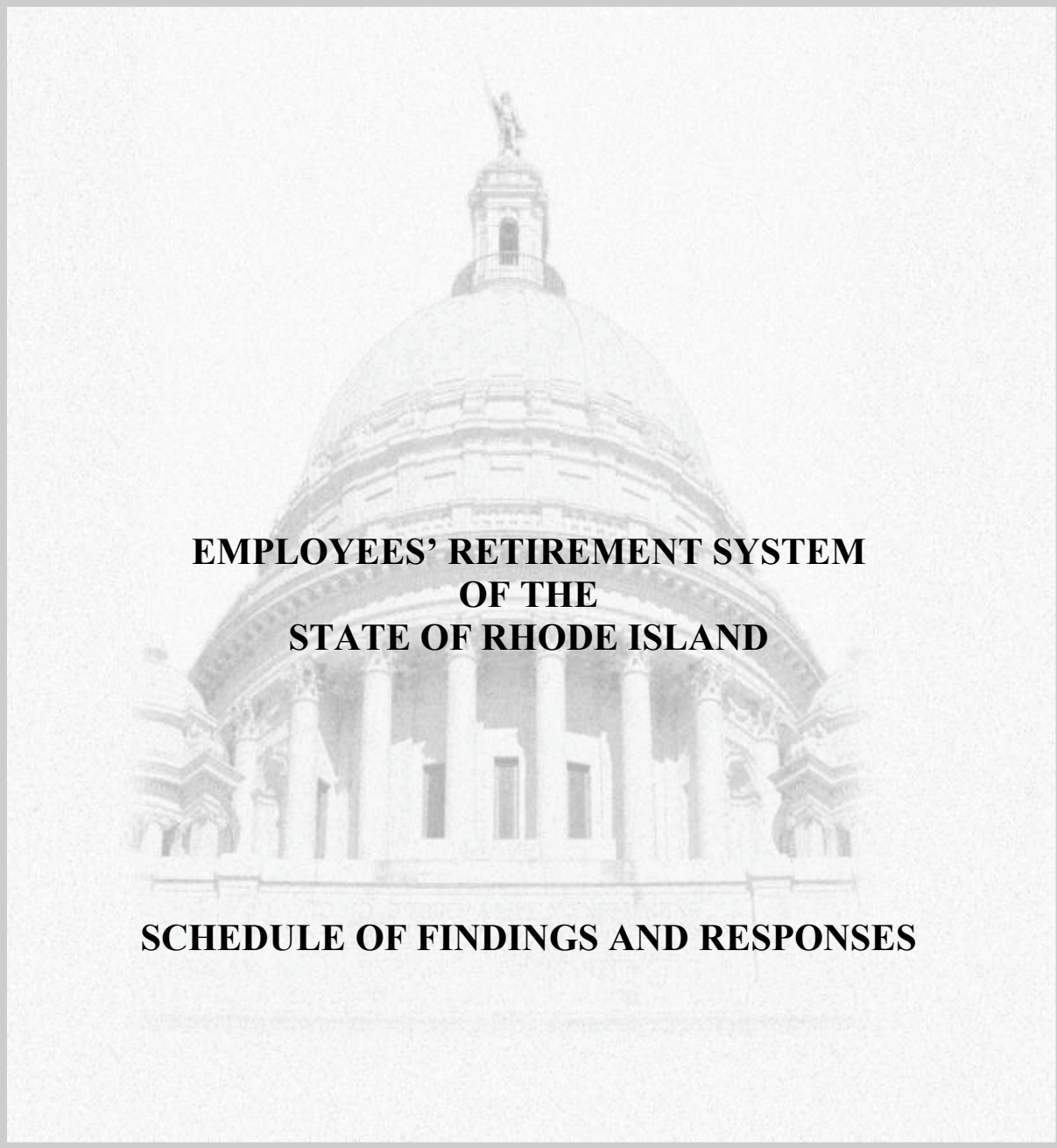
We did, however, note certain other matters that we reported to management of the System in the accompanying Schedule of Findings and Responses.

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 3, 2012



**EMPLOYEES' RETIREMENT SYSTEM  
OF THE  
STATE OF RHODE ISLAND**

**SCHEDULE OF FINDINGS AND RESPONSES**

## Management Comment 2012-1

### SYSTEM ADMINISTRATIVE COSTS

The administrative costs of operating the retirement system are allocated to and paid from the four 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.

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. Similarly, as a result of the Retirement Security Act, a new defined contribution plan was implemented in fiscal 2013.

We noted that a summary budget outlining the costs to be charged to the System is presented to the Board annually but personnel costs are presented in aggregate without a personnel supplement delineating the positions charged 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.

### RECOMMENDATIONS

- |         |  |
|---------|--|
| 2012-1a | Formalize ERSRI Board policy regarding administrative costs to be charged to the Employees' Retirement System.   |
| 2012-1b | Provide enhanced budgetary information to the Retirement Board regarding administrative costs charged to the System including a personnel supplement detailing direct and allocated positions. |

### Auditee Views and Corrective Action Plan:

*Regulation 1(A)5(10) of the Employees' Retirement System of Rhode Island grants the authority to the Retirement Board to approve an annual budget. RIGL §36-8-10.1 establishes a restricted receipt account, under control of the general treasurer, to pay for the expenses of the retirement board, the costs of maintaining the system, and the costs of administering the retirement system. Specifically, the expenses are limited to 17.5 basis points of the average total investments before*



*lending activities as reported in the annual report of the auditor general for the next preceding five fiscal years.*

*Historically, expenses incurred by the System have been in a range of 9 to 12 basis points, well below the statutory limit. The System will continue to present a budget, which is an accumulation of direct and allocated costs; that is compliant with the limit prescribed by statute. ERSRI will work to formalize policies for board approval of administrative costs. ERSRI will work to provide clarity and detail to the board regarding the allocation of expenses and budget approval, including allocations to newly established trusts as appropriate (i.e. OPEB and DC Trust).*

## Management Comment 2012-2

### INVESTMENT EXPENSES

The System's investment custodian is responsible for accounting for all of its investment transactions. The custodian provides various reports to the System which are used to develop the System's financial statements. These reports indicated that investment expenses were nearly \$12.7 million during the fiscal year ended June 30, 2012 and, accordingly, were recorded as such on the System's financial statements. This amount did not, however, include investment expenses associated with hedge funds, and some private equity and real estate investments. Hedge fund investments totaled more than \$1 billion at June 30, 2012 representing 14% of the System's total investment portfolio. Investment expenses for these categories of investments were reported to, and by, the investment custodian as a net reduction to investment income.

Generally accepted accounting principles (GAAP) allow for presenting investment income net of related expenses on the financial statements when the expenses are not readily separable. However, that presentation, while not at odds with GAAP, does represent an inconsistent presentation among the various classes of investments.

We believe the System should attempt to separately identify such expenses whenever possible for enhanced transparency and consistency in financial statement presentation.

### RECOMMENDATION

2012-2            Work with the System's custodian and investment managers to capture additional investment expenses with the goal of presenting investment income and expenses consistently for all investment types.

#### Auditee Views and Corrective Action Plan:

*Direct billed management expenses and those investment costs readily separable from investment income are disclosed as part of the System's audited financials and included in the System's annual report each year. Investment expense reporting for the System conforms to relevant GASB standards (Specifically Statement No. 25, note 12).*

*Beyond meeting these standards, fees are paid in two ways, depending on the conventions of that type of investment:*

*1) Direct-billed management fees are accrued and reported each month as part of the State Investment Commission report. This monthly report is a cash flow tool that tracks directly billed management fees. These fees are generally paid quarterly.*



2) Indirect management and performance fees, per industry standard, are not directly billed to the state and are incorporated in net performance. Generally, funds collect performance fees on an annual basis (hedge funds) or cumulatively over the life of the investment (private equity). We are working to integrate reporting of these expenses into the annual reporting cycle. Improving the scope of these additional disclosures is a top priority for System management.

One of Treasury's top priorities is transparency and accountability. Treasury built, launched and maintains the state's first online Investor Relations Portal. Only a few state public pensions disclose performance fees and there is no applicable accounting standard that provides guidance on how best to report indirect management and performance fees, System staff will work with all stakeholders, including the Auditor General to enhance the investment expense disclosures in the annual reporting cycle.

### Management Comment 2012-3

#### IMPROVE PROCEDURES TO REPORT CONCENTRATION OF CREDIT RISK IN THE ANNUAL FINANCIAL STATEMENTS

Generally accepted accounting principles require disclosing any concentration of credit risk defined as an investment in any one issuer that constitutes more than 5% of the overall investment portfolio. The data used to identify any such concentration of credit risk and prepare the required disclosures is typically provided by the System's investment custodian. Since a significant portion of the System's investments are not individual securities directly held by the custodian but are commingled funds, hedge funds, limited partnerships, etc., "looking through" to the underlying investment and quantifying aggregate exposure can be complicated.

The System acknowledged that the reports provided by the custodian at June 30, 2012 did not fully meet the disclosure requirement. Additional data was sought from certain of the System's investment consultants in an attempt to identify and aggregate total investment in any one issuer regardless of whether it was a direct or indirect holding. Practically, these procedures were more directed at demonstrating that the risk of aggregate exposure greater than 5% was limited rather than accurately quantifying aggregate exposure. Consequently, such procedures could be improved for fiscal 2013. Subsequent to June 30, 2012, the System transferred custody of its assets to a new custodian. The System should work with the new custodian to ensure information, required to meet the disclosure requirements of generally accepted accounting principles, is available for financial reporting purposes. The information is also useful from a portfolio management perspective to identify unintended risk concentration exposure that is not readily transparent.

#### RECOMMENDATION

2012-3            Work with the System's custodian to capture all data needed to meet the concentration of credit risk disclosures required by generally accepted accounting principles.

#### Auditee Views and Corrective Action Plan:

*The System will continue to work with its consultants and custodian to capture all data to meet the concentration of credit risk disclosures. Our consultants continue to monitor top holdings to ensure we stay well below the 5% threshold. Calculating the maximum exposure (worst case scenario) shows our top holding could not exceed 2.1% of the overall ERSRI portfolio, well below the allowed 5%. As Industry-wide "look through" holdings data for hedge funds are not*

available to client custodians, ERSRI's available information is consistent with conventional practice.

### Management Comment 2012-4

#### IMPROVE CONTROLS OVER THE IDENTIFICATION, TRACKING AND COLLECTION OF DELINQUENT CONTRIBUTIONS

We noted two employer units which were significantly delinquent in remitting required contributions to the System. The System can improve its process to formally notify the delinquent employer units and commence timely action to collect the contributions due the System.

One of the units (fire district) made minimal contributions to the System for fiscal 2012 and owed nearly \$500 thousand at fiscal year-end. In addition, one municipality was significantly behind in remitting contributions due to cash flow issues and owed contributions of more than \$1 million at June 30, 2012. In some instances, the General Laws provide the System with the ability to offset contributions due against state aid payments to a municipality. There are no offset provisions that can be utilized with respect to fire districts. The municipality in question received an advance on their education aid due to their cash flow situation thereby limiting the opportunity for offset. Regardless, the System should have more aggressively pursued collection of contributions. There were no letters or other documented collection actions taken by the System, although System employees indicated they were aware of the delinquencies and had phone communications with the employer units.

Prompt identification of delinquencies and prompt follow-up are key components of effective collection efforts. Further, appropriate written notification of delinquencies to the governing body of the employer unit, the Retirement Board, and other interested parties should be made when delinquencies persist after a reasonable time period.

#### RECOMMENDATION

2012-4            Initiate appropriate and timely collection action for employer units which are delinquent in their contributions. Formalize and document collection efforts and related notifications when delinquencies persist after a reasonable time period.

#### Auditee Views and Corrective Action Plan:

*The System places great importance on the collection of contributions in a timely manner and has an enhanced and documented policy for the collection of contributions due to the System. Based on frequent discussions and monitoring, the System is and has been aware of all potential collection delays and issues. The employers mentioned in this comment have unique issues that do not represent a systemic problem in the area of collections of monies that are owed to ERSRI.*

*The employer was remitting the employee contributions to ERSRI within the statutory requirements. Also, ERSRI was aware that the municipality received significant state-aid payments twice a year. Knowing the timing of the aid payments and ERSRI's legal authority to withhold aid payments in cases of delinquency, ERSRI was confident that the employer contributions would be remitted to the System. As contributions were remitted ERSRI staff monitored the fiscal situation of the municipality to determine if legal action was required. In July of FY13, as expected, the employer unit remitted a payment to ERSRI and satisfied their outstanding financial obligation. Also, as of the date of this report the employer is current on all of its required contributions to ERSRI.*

*As for the fire district ERSRI is following the appropriate legal channels to collect all outstanding contributions. In addition, this fire district has been placed under the control of a Special Master, which was appointed by the State of Rhode Island. Since the installment of the Special Master all contributions from the inception date have been remitted to ERSRI.*

## Management Comment 2012-5

### **IMPROVE CONTROLS OVER THE REPORTING OF CONTRIBUTIONS RECEIVABLE**

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 for financial reporting purposes.

Our 2012 audit found an instance where the receivable balances (and related revenue) were misstated by \$1.7 million. Specifically, the System performs an analysis at year-end to calculate employee and employer contributions accruals for the teacher units in the ERS fund and MERS units. Due to a combination of the query programming and the timing of the last day of the fiscal year, the query excluded amounts inappropriately. Our audit procedures in prior years also found several instances where one or more of the contributions receivable balances were misstated.

The system should enhance 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 ensuring the completeness of the receivables balances for financial reporting purposes. Additionally, as the System works with its contractor in the development of its new computer system, it should ensure that the current system weaknesses are addressed by enhanced functionality within the new system.

### **RECOMMENDATIONS**

- |         |  |
|---------|--|
| 2012-5a | Enhance control procedures over the manual processes used to calculate contributions receivable at fiscal year-end for financial reporting purposes. |
| 2012-5b | Ensure the development of the new computer system addresses the current system weaknesses through enhanced functionalities.                          |

### **Auditee Views and Corrective Action Plan:**

*2012-5a - For FY2012 the System collected contributions in excess of \$582 million. The \$1.7 million audit adjustment represents 0.29% of the balance at year-end. ERSRI has implemented a preventative measure in the query to account for the timing of the last day of the fiscal year and the posting of contributions. In addition, ERSRI will review and make the necessary operational revisions to the procedures and analysis that are performed for the reporting of contributions receivable for financial reporting purposes.*

2012-5b – ERSRI has procured a new accounting system in addition to an updated line-of-business system in which it will develop, with the assistance of the selected vendor, enhanced capability for computing, recording, and tracking accounts receivable.

### Management Comment 2012-6

#### **IMPLEMENT 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; however the plan has not yet been implemented. The plan should be implemented 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 a 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**

2012-6            Implement 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. ERSRI is currently identifying appropriate resources necessary for implementation of the plan.*

### Management Comment 2012-7

#### **EXPAND INFORMATION TECHNOLOGY RESOURCES**

ERSRI's computer system is supported by a contract vendor who is essentially responsible for all operations and security of ERSRI's IT systems.

ERSRI should consider adding additional IT resources to properly implement its IT Governance and Strategic Plan thereby enhancing oversight of critical IT System functions. Additionally, these resources could provide assistance and oversight regarding the future technical and security issues facing ERSRI in development and implementation of its new "cloud-based" retirement administration and general ledger system. Without adding IT resources, project management will fall to existing staff, and could negatively impact performance of their current duties. Once the new system is implemented, an IT specialist will be required to provide adequate oversight of the contracted IT services.

RECOMMENDATION

2012-7 Add additional Information Technology resources to implement the IT Governance and Strategic Plan, oversee the system responsibilities performed by the current contracted IT vendor, and serve as a resource regarding the future technical and security issues associated with development of ERSRI's new computer system.

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. During fiscal year 2013, ERSRI expanded its IT resources with the addition of a Business Analyst and an onsite IT hardware support person. In collaboration, with its IT consultant ERSRI is spending time reviewing the IT Strategic Plan to ensure that there will be sufficient resources dedicated to information technology.*

**Management Comment 2012-8****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

2012-8 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 IT Governance and Strategic Plan. The System maintains Change Control Request documentation when implementing major programmatic changes. Major changes, such as the recent pension reform, are monitored through the change order process. Also, we will explore available options with the approved core system replacement vendor.*

**Management Comment 2012-9****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**

2012-9a      Develop a plan to review member records to ensure all member accounts have accurate service credit data.



**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**

2012-9b 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.

**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**

2012-9c Implement on-line membership enrollment as part of the implementation of the System's new computer system.

**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 15<sup>th</sup> 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**

2012-9d Require member units to remit contributions to the System electronically rather than by check.



- 2012-9e Seek amendment to the General Laws to require remittance of contributions by employers within five business days of the payroll date.

### **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**

- 2012-9f 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**

- 2012-9g 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:**

*2012-9a - ERSRI is 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 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.*

*2012-9b – 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.*

*2012-9c – ERSRI has procured a new line-of-business system with on-line capability. Upon project completion, this process may be available and we will contemplate its use then.*

2012-9d and 2012-9e – The replacement line-of-business and general ledger systems will establish the electronic remittance of contributions. Also, 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. ERSRI will again examine legislative efforts involved and make appropriate determinations.

2012-9f and 2012-9g – ERSRI has made this a requirement in its system upgrade. The selected vendor will provide software and on-site auditing ability.

## Management Comment 2012-10

### **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 (dated December 15, 2011) covering a number of areas. We believe these regulations should be expanded to codify various policies which have been informally developed covering additional topics such as:

- 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.

Specifically, regarding the frequency of actuarial audits, the Employees' Retirement System of Rhode Island (the System) is in the process of selecting an independent actuary to perform an audit of its most recent valuations (as of June 30, 2012). However, the ERSRI Board has not adopted a policy regarding the frequency or scope of the actuarial audits.

The general purpose of an actuarial audit is to obtain an independent opinion as to whether or not the valuations were performed accurately using reasonable methods and assumptions. Actuarial audits provide some assurance to plan trustees that the financial condition of the plan, as presented by the plan's actuary, is accurate.

The Government Finance Officers Association (GFOA) recommends that actuarial audits be completed at least every five years – or sooner if there is a change in actuary. ERSRI last obtained an actuarial audit of the valuations for the fiscal year ended June 30, 2003 (it has employed the same actuary since that time). We believe it would also be beneficial to establish a policy consistent with the best practices recommended by GFOA to initiate actuarial audits at predetermined intervals.

RECOMMENDATIONS

- 2012-10a Codify all existing policies and promulgate various informal policies used in the administration of the System.
- 2012-10b Establish a policy in line with the best practices recommended by GFOA to initiate actuarial audits at predetermined intervals.

Auditee Views and Corrective Action Plan:

*2012-10a - 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.*

*ERSRI has a policy, recommended by the Actuary and approved by the Board, on the method for determination of cost of living adjustments.*

*2012-10b – The ERSRI Board has a policy to perform actuarial audits every 5-8 years as prescribed by the GFOA. The system is currently performing an audit. ERSRI will consider formalizing/codifying the policy.*

**Management Comment 2012-11****REVISE THE TIME FRAME FOR SUBMITTING THE SYSTEM'S ANNUAL REPORT**

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 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 some months or a year later becomes redundant and unnecessary.

Instead, the System may 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.

#### RECOMMENDATION

- 2012-11a      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.
- 2012-11b      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:

*2012-11a – 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.*

*2012-11b – ERSRI will consider the resources involved in preparing and distributing this information. All financial and actuarial information are contained on the ERSRI website and Treasury’s Investment Portal.*

### **Management Comments Communicated Confidentially 2012-12 and 2012-13**

As permitted by General Law section 22-13-10, *Audit of Information Security Systems*, we have communicated two findings confidentially that relate to security over ERSRI’s computer systems.

**MANAGEMENT COMMENTS APPLICABLE TO FUTURE OPERATIONS****Management Comment 2012-14****DEFINED CONTRIBUTION PLAN – FINANCIAL REPORTING CONSIDERATIONS**

The Retirement Security Act enacted in November 2011, created a defined contribution plan to supplement the existing ERS and MERS defined benefit plans. Employers and employees began contributing to the defined contribution plan on July 1, 2012.

The manner in which the defined contribution plan should be presented both within the System's financial statements and the State's financial statements must be explored and resolved consistent with generally accepted accounting principles. This should be done expeditiously to allow sufficient time to accumulate the information needed for financial reporting purposes. Options include presenting the defined contribution plan within the System's financial statements, presenting it separately, or providing note disclosures about the plan in both the System's and State's financial statements without a full presentation of the financial activity of the defined contribution plan.

**RECOMMENDATION**

2012-14      Ascertain the appropriate financial statement presentation for the newly implemented defined contribution plan.

**Auditee Views and Corrective Action Plan:**

*ERSRI has been in contact with TIAA-CREF, the plan administrator, and is taking the necessary steps to research the presentation of the defined contribution plan for FY2013.*

**Management Comment 2012-15****ACCOUNTING FOR NEW CONTRIBUTIONS FROM NON-MEMBER JUDGES**

Pension reform legislation enacted in November 2011 required that active judges who were appointed prior to December 31, 1989, have a "retirement contribution" of 8.75% withheld (effective July 1, 2012) from their salary similar to the employee contribution for other state employees. These judges (active non-member judges) are not members of the Judicial Retirement Benefits Trust but instead will receive a pension that is appropriated and paid from the annual budget of the Judiciary.

The "retirement contribution" withheld from compensation paid to the judges is currently treated as a "pre-tax" contribution similar to the manner in which the employee share of retirement contributions for other state employees is treated. In order for the "retirement contribution" to be treated as a "pre-tax" deduction (deducted before the determination of income tax withholding amounts) the contributions must be made to a qualifying governmental pension trust. These active non-member judges are not members of the Judicial Retirement System plan that would qualify the contributions to be treated as a pre-tax item.

Presently, the contributions are being withheld from compensation paid to the active non-member judges in compliance with the Retirement Security Act. However, the contributions are now only being held in a separate bank account rather in a qualifying governmental pension trust until various issues can be resolved.

While the dollar amount of such contributions is minimal, compliance with the General Laws and IRS regulations presents an accounting and financial reporting conundrum. Placing the active non-member judges contributions within an existing or new trust implies that these judges should likely be included in an actuarial valuation of the existing judicial plan (or a new “plan”). Their inclusion in the valuation would impact the funded status and required employer contribution. On the other hand, not depositing the employee withheld contributions in a qualifying trust jeopardizes the “pre-tax” status of the contributions for tax withholding purposes.

#### RECOMMENDATION

2012-15      Resolve the tax withholding, accounting, and financial reporting issues associated with the employee contributions required of active non-member judges.

#### Auditee Views and Corrective Action Plan:

*The class of non-member judges, that effective July 1, 2012, that are required to have retirement contributions withheld is approximately 9 individuals. ERSRI is currently consulting with its tax and legal counsels to assisting in determining the most appropriate way to handle the reporting of these individuals.*