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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, 2013**

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**

[oag.ri.gov](http://oag.ri.gov)

86 Weybosset Street • Providence, RI • 02903-2800  
tel: 401.222.2435 • fax: 401.222.2111

April 3, 2014

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER Nicholas A. Mattiello, Chairman

Senator M. Teresa Paiva Weed

Senator Dennis L. Algieri

Representative John J. DeSimone

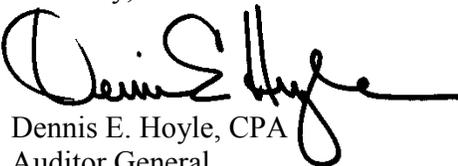
Representative Brian C. Newberry

We have audited the financial statements of the Employees' Retirement System of the State of Rhode Island (the "System") for the year ended June 30, 2013 and have issued our report thereon dated December 19, 2013. 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, 2013*.

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, 2013

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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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86 Weybosset Street • Providence, RI • 02903-2800  
tel: 401.222.2435 • fax: 401.222.2111

**INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER  
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS  
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED  
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

JOINT COMMITTEE ON LEGISLATIVE SERVICES, GENERAL ASSEMBLY  
STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS:

RETIREMENT BOARD OF THE EMPLOYEES' RETIREMENT SYSTEM OF THE  
STATE OF RHODE ISLAND:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the plans within the Employees' Retirement System of Rhode Island (System) as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the System's basic financial statements, and have issued our report thereon dated December 19, 2013.

## **Internal Control Over Financial Reporting**

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

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify a deficiency in internal control, described as Finding 2013-1 in the accompanying *Schedule of Findings and Responses* that we consider to be a significant deficiency.

### **Compliance and Other Matters**

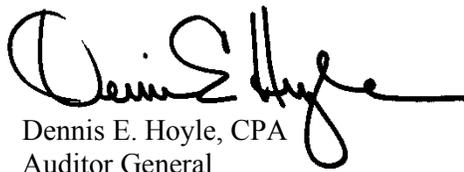
As part of obtaining reasonable assurance about whether the System's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

### **The System's Response to Findings**

The System's response to the findings identified in our audit are described in the accompanying *Schedule of Findings and Responses*. The System's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

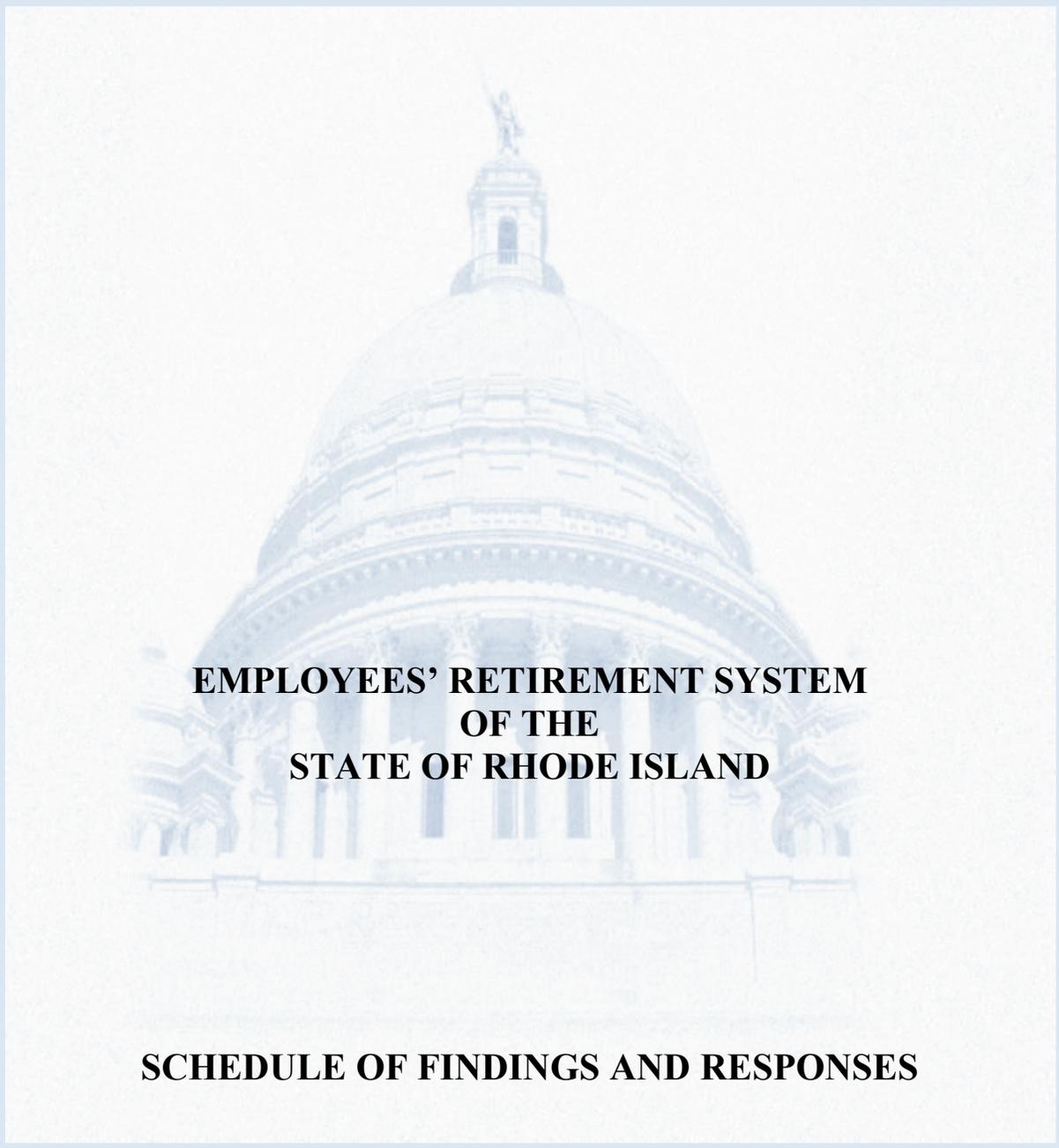
### **Purpose of this Report**

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



Dennis E. Hoyle, CPA  
Auditor General

December 19, 2013



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

**SCHEDULE OF FINDINGS AND RESPONSES**

**Finding 2013-1****INVESTMENT ACCOUNTING**

The System's investments are held by an independent custodian who also maintains all the accounting records related to those investments including the reporting of investment income and expenses. For financial reporting purposes, summarized information is recorded at the close of the fiscal year based on information provided by the custodian. Due to this arrangement, the System is reliant on the controls and accounting records maintained by the custodian.

Understanding and monitoring the activities of the investment custodian is a critical control area, particularly when the custodian's records are the only accounting records maintained. We found that the System can improve its understanding and oversight of the custodian's accounting policies, controls, and procedures to ensure investment transactions are reported on the System's financial statements consistent with its accounting policies.

The System transferred its investments to a new custodian effective November 1, 2012. We found that the new custodian (1) recorded certain transactions differently than the prior custodian and (2) certain other transactions required reclassification. The System accepted our proposed audit adjustments, which reclassified \$3.1 million to the financial statement line item "investment expense" from "net appreciation in fair value of investments". While these situations are partly attributable to transitioning to a new investment custodian, we believe the System should enhance its monitoring controls over the custodian's accounting and reporting of transactions to allow timely identification and correction of variances or errors.

There is a substantial volume of information provided on the System's investments by each of the various investment managers engaged by the State Investment Commission as well as the System's investment custodian. We observed that the review and reconciliation of such information to the custodian's records could be improved with the goal, among others, of providing enhanced documentation for financial reporting purposes.

Additionally, investment staff overseeing the System's investment portfolio is organizationally separate from the Retirement Division and consequently independent from the accounting and financial reporting processes of the Division. This contributes to a split responsibility for (1) information included within the System's financial statements and (2) the design and operation of key controls over financial reporting.

These organizational areas should be better integrated to enhance controls over financial reporting with regard to investments and related disclosures. This includes ensuring that those individuals responsible for preparing the System's financial statements in accordance with generally accepted accounting principles include important investment activities within that scope of work.

**RECOMMENDATIONS**

- |         |   |
|---------|---|
| 2013-1a | Enhance the understanding and monitoring of the accounting and reporting activities performed by the System's investment custodian.       |
| 2013-1b | Enhance controls over financial reporting by better integrating responsibility for the investment cycle with all other System activities. |

Auditee Views and Corrective Action Plan:

*During Fiscal 2013 Treasury converted to a new custodian on November 1, 2012, saving the system more than \$300,000 annually. We had maintained a relationship with our prior custodian for 25 years, and mechanical and accounting processes had been worked out and refined over time.*

*Our custodian provides the accounting function for our investments. To supplement the custodian, staff has a thorough process to review activity on a monthly basis. Further, in the case of private equity and real estate transactions, we reconcile transactions with the custodian bank (Bank of New York Mellon) and the consultants (Cliffwater for private equity and Pension Consulting Alliance for real estate) in a three-way reconciliation.*

*During the set-up process with Bank of New York Mellon (BNY), we reviewed the methods of recording and valuation of our investment partnerships. There are three widely accepted methods for accounting: cost method, equity method, and hybrid method. With the previous custodian, we had used a hybrid method. At inception with BNY, we elected to use the cost method. This method is used by 65% of BNY's clients because it allows BNY to reconcile with the consultant and partnerships in the most efficient way. The cost method is the accounting method used by both the partnerships and consultant; it is fully GAAP compliant.*

*At no time was the bottom-line valuation of the partnerships different from that of the hybrid method, meaning that the pension fund's balance and performance were always properly recorded. There was no change to the bottom line. As is the case with the cost method, those expenses are realized as a component of the realized and unrealized losses of the partnership (It is considered a loss because at the time of payment these transactions are recorded as purchases and later reclassified).*

*Based on the concerns of the Auditor General, we have switched to the hybrid method, an accounting treatment used by only 4% of BNY clients. Under the hybrid method, the custodian will post management fees and partnership expenses in the "fees and expenses" category on a quarterly basis when they reconcile valuations. Remaining valuation adjustments, including indirect fees, will be posted to unrealized gains and losses. For the January 2014 statements, the first quarter of fy14 will be reconciled and expensed accordingly. Due to timing of quarterly reconciliations, the fees for fiscal fourth quarter will be accrued and subsequently reversed.*

*Staff continues to enhance its understanding and monitoring of the accounting and reporting activities of the System's investment custodian. We also continue to work closely with the Retirement accounting department and its additional staff to ensure the most accurate representation and categorization on the financial statements.*

## Management Comment 2013-2

### SEEK TO MERGE THE TWO JUDICIAL PENSION PLANS

A new pension plan – the Rhode Island Judicial Retirement Fund Trust (RIJRFT) - covering just 7 active judges was created during fiscal 2013. The new plan resulted from enactment of the Retirement Security Act of 2011 and required the 7 active judges who were appointed before January 1, 1990 to begin making an employee pension contribution. Judges appointed after December 31, 1989 are members of a separate judicial pension plan – the Judicial Retirement Benefits Trust (JRBT). Other retired judges who were appointed prior to January 1, 1990 are provided pension benefits through an appropriated pay-as-you-go plan.

While the plan was established and began receiving employee contributions from the judges, the State has not yet begun to make employer contributions to the plan. The first actuarial valuation of the plan (performed as of June 30, 2012) utilized actuarial assumptions consistent with the fact that the State has not begun to fund the plan on an advance funding basis.

The ERSRI Board should consider whether the two judicial plans could be merged into one plan for ease of administration and to avoid the widely divergent funded status of the plans – the JRBT at 83.4% (as of June 30, 2012) and the new RIJRFT at 0.0%. The State as the employer is equally obligated for all judicial pensions whether provided through a pay-as-you-go mechanism or through the two established judicial pension trusts. The only distinction, as provided in the General Laws, is the date of judicial appointment. Consequently, funding one plan such that it is nearly fully funded while making no employer contribution to the other is inconsistent with the actual equal obligation of the State as the employer.

Similarly, the idea of including all active and retired judges under one plan, including those that are presently provided a pension through an appropriated pay-as you go funding mechanism, should be explored. The incremental cost of making an actuarially determined contribution for all active and retired judges should be compared to the current costs for some on a pay-as you-go basis and others on an actuarially-determined basis.

#### RECOMMENDATIONS

- |         |   |
|---------|---|
| 2013-2a | Seek to merge the two judicial retirement benefit trusts.   |
| 2013-2b | Determine the incremental cost of funding all judicial pensions on an actuarially determined basis. |

#### Auditee Views and Corrective Action Plan:

1. *Potential Violation of Fiduciary Duty. There is concern that merging the trusts together could cause a breach of fiduciary duty. In part, plan fiduciaries have the responsibility to protect and preserve fund assets for the benefit of all participants. Merging the non-contributory trust with the contributory trust could in effect dilute the contributory trust retirement assets. In ratifying an action to merge the trust, the question arises as to whether the plan fiduciaries are acting in the best interest of the participants in the contributory plan (i.e., are benefits being protected if merging the funds results in an unfunded status for the contributory plan?). There is also the possibility that the sixty participant judges in the contributory trust will be concerned about this arrangement and may view this as a negative impact upon their retirement benefits.*

2. *RIRSA COLA. The RIRSA COLA provisions (enacted November 18, 2011) suspend COLA for all state employees, teachers, state police and judges until the plans' funding level for all groups, calculated in the aggregate, exceeds an 80 percent funding level. The merging of the trusts may, in the aggregate, reduce the funding level of the "merged trusts" to an 80 percent or less funding level. Since the non-contributory trust is currently a "pay-as-you-go" arrangement that is separate and apart from the contributory trust, this arrangement may not be a current factor with respect to the COLA suspension. But by merging the trusts together, there is a broader concern that the noncontributory trust dilution of the contributory trust could negatively impact not only the application of the COLA for the judges, but for other groups of employees as well.*
  
3. *Potential Violation of Statute. RIGL Chapter 8 specifically provides that "... receipts (i.e. contributions) collected under this provision shall be deposited in a restricted revenue account entitled "Judicial retirement benefits." Proceeds deposited in this account shall be held in trust for the purpose of paying retirement benefits to participating judges or their beneficiaries. " An argument could be made that merging the trusts will not comply with the current RIGL as the funds under the contributory plan are to be used specifically for the purpose of paying retirement benefits to participating judges....i.e., not for the purposes of paying retirement benefits to participating judges under the noncontributory plan.*

### Management Comment 2013-3

#### FINANCIAL REPORTING FOR THE TEACHERS SURVIVOR BENEFIT PROGRAM

The Teachers Survivor Benefit Program (TSB) covers certain participating teachers who do not participate in federal Social Security and provides a survivor benefit to spouses, children and dependent parents. The cost of the benefits provided by the plan are two percent (2%) of the member's annual salary up to but not exceeding an annual salary of \$9,600; one-half (1/2) of the cost is contributed by the member by deductions from his or her salary, and the other half (1/2) is contributed and paid by the respective school district by which the member is employed. These contributions are in addition to the contributions required for regular pension benefits.

The TSB Program is authorized by the General Laws which also require that a separate actuarial valuation of the plan be performed every two years. For accounting and financial reporting purposes, the TSB program is included within the ERS plan. Net position of this program, which totaled \$138 million at June 30, 2013 is appropriately segregated within the System's accounting records. Similarly, TSB activity and net position is appropriately excluded by the actuary in performing the actuarial valuation of the ERS plan.

The System should strongly consider reporting the TSB program discretely in its financial statements (e.g., as a separate column rather than included within the ERS plan). Such presentation would improve financial reporting by more clearly segregating the TSB program activity from the separate ERS plan.

#### RECOMMENDATION

- |        |   |
|--------|---|
| 2013-3 | Report the Teachers Survivor Benefit Program as a discrete column within the System's financial statements. |
|--------|---|

Auditee Views and Corrective Action Plan:

ERSRI concurs with the finding and will consider segregating the TSB information for FY14 for reporting purposes.

<b>Management Comment 2013-4</b>
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**RECOVER BENEFIT OVERPAYMENT AND ENHANCE CONTROLS TO PREVENT A RECURRENCE**

Upon retirement, state employees and teachers may select what is known as the Service Retirement Allowance Plus option (SRA Plus option) which provides for the payment of a larger benefit before the attainment of age 62 and a reduced amount thereafter. The larger benefit is equal to the retiree's regular benefit plus a supplement equal to an actuarially-determined factor multiplied by the member's estimated social security benefit payable at age 62.

There were 28 members that retired under the SRA Plus option in fiscal 2013. We found that the benefit provided to one of these members was calculated incorrectly on September 7, 2012 resulting in an overpayment of \$101 per month since that time (totaling \$1,616 through December 2013). This error was caused by the fact that the actuarially-determined factor used to calculate the SRA Plus benefit was revised effective July 1, 2012 to reflect the new benefit provisions associated with the Rhode Island Retirement Security Act of 2011 -- and this revision was not communicated to the system's staff nor was it programmed into the ERSRI computer system until after the subject pension was calculated.

The System should improve its control procedures to ensure that necessary changes to benefit calculations are programmed into the ANCHOR application system in a timely manner. Additionally, the System should communicate all such changes to retirement staff in written form and on a timely basis.

RECOMMENDATION

2013-4            Recover benefit overpayment and ensure that necessary changes to benefit calculations are programmed and communicated to staff on a timely basis.

Auditee Views and Corrective Action Plan:

*When changes occur to the benefit or any other structure, ERSRI has a documented change control procedure to ensure any and all changes are implemented in accordance with enacted Rhode Island General Laws. The change controls are communicated to ERSRI's IT vendor, developed, approved by the management of ERSRI, and tested by appropriate staff.*

*Accordingly, ERSRI then communicates changes to the appropriate staff after successful testing and implementation. In the single example cited above, given the vast number of changes being implemented due to the enactment of RIRSA, ERSRI concurs that a benefit overpayment was made and will be recovered.*

## Management Comment 2013-5

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

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

TIAA-CREF, as the plan administrator/record keeper has sought approval from the IRS for System's newly formed defined contribution plan which is pending before the IRS. Similarly, we inquired about any necessary IRS approvals required for the new Judicial Retirement Fund Trust plan which began operations during fiscal 2013. We observed that formal determination letters confirming the qualifying status of all the System's defined benefit plans have not been sought from the IRS. The State did enter into an "Agreement as to Final Determination of Tax Liability and Specific Matters" with the Internal Revenue Service in 1994 primarily to resolve issues related to the prior withdrawal of contributions. That agreement addressed various plan compliance matters.

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

- minimize the risk that the IRS will disqualify the plan on audit because the plan document doesn't satisfy the applicable tax-qualification requirements, and
- use certain IRS correction programs to correct plan errors."

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

#### RECOMMENDATION

2013-5            Seek formal determination letters from the Internal Revenue Service regarding the qualifying status of the System's defined benefit plans.

#### Auditee Views and Corrective Action Plan:

*ERSRI has in fact received a determination IRS letter entitled "Tax Liability and Specific Matters" dated February 4, 1994 in which the IRS noted that the plan is intended to be a qualified plan under section 401(a) of the code. As required by the letter, Rhode Island General Laws were amended in the 1994 legislative session to add RIGL 36-8-20 Internal Revenue Code Qualification.*

*ERSRI always strives to consider and implement best practices whenever possible and/or practical. As noted, ERSRI has been in the process with tax counsel to review, update, and make any necessary recommendations, if applicable. At the conclusion of the analysis, communication with the IRS will be addressed.*

## Management Comment 2013-6

### SYSTEM ADMINISTRATIVE COSTS

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

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

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

During fiscal 2013, no administrative costs were allocated to the new defined contribution plan because a separate appropriation was made for such costs in the first year of operation. No allocation of administrative costs was made to the newly created Rhode Island Judicial Retirement Fund Trust due to its size relative to the other trusts.

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

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

As fiduciaries of the plans within the System, the Board's approval of administrative costs would supplement the annual legislatively approved appropriation for the System from a restricted receipts account within the State's General Fund. A formal policy statement would guide (1) which costs are

deemed appropriate as expenses of the various trusts within the System and (2) the equitable distribution of such expenses when shared by multiple plans/trusts.

### RECOMMENDATIONS

- 2013-6a Formalize ERSRI Board policy regarding administrative costs to be charged to the Employees' Retirement System.
- 2013-6b Provide enhanced budgetary information to the Retirement Board regarding administrative costs charged to the System including a personnel supplement detailing direct and allocated positions.
- 2013-6c Ensure the allocation methodology used to distribute administrative costs to all the benefitting trust funds results in an equitable distribution of such costs.

#### Auditee Views and Corrective Action Plan:

*Regulation 1(A) 5(10) of the Employees' Retirement System of Rhode Island provides authority to the Retirement Board to approve an annual budget. ERSRI will work to formalize policies for board approval of administrative costs. ERSRI has provided clarity and detail to the board regarding the allocation of expenses during the budget approval process.*

## **Management Comment 2013-7**

### COMPLETE IMPLEMENTATION OF THE INFORMATION TECHNOLOGY GOVERNANCE AND STRATEGIC PLAN

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

#### RECOMMENDATION

- 2013-7 Complete implementation of the IT Governance and Strategic Plan developed for ERSRI.

#### Auditee Views and Corrective Action Plan:

*During FY2012, the System developed a comprehensive Information Technology Governance and Strategic Plan. ERSRI is currently identifying appropriate resources necessary for implementation of the plan.*

**Management Comment 2013-8****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**

2013-8            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 will review the IT Strategic Plan to ensure that there will be sufficient resources dedicated to information technology.*

**Management Comment 2013-9****ENHANCE MONITORING OF THE CONSULTANT CHANGE MANAGEMENT PROCESS**

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

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

**RECOMMENDATION**

2013-9 Enhance oversight of the program change management function as performed by the System's contracted IT vendor. Receive and review change logs and determine if they are authorized and in accordance with documented management directives.

**Auditee Views and Corrective Action Plan:**

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

**Management Comment 2013-10****INCLUDE FUNCTIONALITIES IN ERSRI'S NEW COMPUTER SYSTEM**

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

**Accurate Member Service Credit Data**

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

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

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

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

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

#### RECOMMENDATION

2013-10a      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

2013-10b      Explore options to increase automation of the reconciliation process with the System's financial institutions by seeking electronic bank reconciliation functionality within the new general ledger package.

#### **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

2013-10c      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 15th of the month following the month in which the payroll was paid. Requiring remittance of contributions electronically within five business days of the payroll date would speed the availability of contributions to the system and is generally consistent with the remittance requirements for federal, state and FICA taxes paid by employers.

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

#### RECOMMENDATIONS

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|----------|---|
| 2013-10d | Require member units to remit contributions to the System electronically rather than by check.  |
| 2013-10e | 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

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| 2013-10f | Include the functionality to log changes to critical system data elements within the new computer system under development. |
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#### 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

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| 2013-10g | Ensure that the new pension administration system has a fully automated application change management system in place, which will allow ERSRI to monitor and verify that all authorized changes were properly made, and to identify any unauthorized changes. |
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Auditee Views and Corrective Action Plan:

2013-10a - 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.

2013-10b - 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.

2013-10c - ERSRI has procured a new line-of-business system with on-line capability. Upon project completion, this process will be available.

2013-10d and 2013-10e - 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.

The Board's legislative subcommittee is currently considering proposed language for submission in the 2014 session. The legislation will seek to collect contributions from member units in shorter time period than currently prescribed in Rhode Island General Laws.

2013-10f and 2013-10g - ERSRI has made this a requirement in its system upgrade. The selected vendor will provide software and on-site auditing ability. Under ERSRI's system replacement, ERSRI will be able, at the vendor's premises, to conduct an audit (i) to confirm that security and data protection protocols utilized by the vendor comply with NIST or other industry acceptable standards; and (ii) to satisfy ERSRI's own audit or governance and oversight requirements.

<b>Management Comment 2013-11</b>
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**PROMULGATE AND CODIFY POLICIES FOR VARIOUS PENSION ADMINISTRATION ISSUES**

Administration of the System is largely governed by specific statutes regarding membership, required contributions, actuarial matters, and benefit provisions. However, in certain instances, statutes are not specific to all situations and therefore various issues require judgment, interpretation of various statutes individually or collectively, consultation with the System's actuary, or decision by the ERSRI board. At times, precedent and past practices are used to guide various administrative decisions. The System has promulgated regulations covering a number of areas. We believe these regulations should be

expanded to codify various policies which have been either formally or informally developed, and others which have not yet been established. Examples of the types of policies recommended for codification include:

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

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

#### RECOMMENDATION

2013-11            Codify all existing polices and promulgate various informal policies used in the administration of the System.

#### Auditee Views and Corrective Action Plan:

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

*For example, ERSRI has a policy, recommended by the Actuary and approved by the Board in May of 2012, on the method for determination of cost of living adjustments.*

### **Management Comment 2013-12**

#### **REVISIT THE SYSTEM'S ANNUAL REPORT PROCESS**

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

The Retirement Division should revisit the current annual report process with the aim of ensuring information is available in the most timely and efficient manner. We suggest the Retirement Division explore amendment of the section of the General Laws (36-8-8) regarding the annual report to reflect a

more current view towards the timeliness of financial data and also modify the other types of data currently required which is not provided in the System's annual reports. Further, the mode and manner in which System information is made available has changed dramatically since the enactment of the General Law provision. Audited financial statements are available on-line immediately upon completion of the audit and actuarial valuations are similarly made immediately available on-line upon acceptance by the Board. Consequently, a separate communication including these items nearly a year later becomes redundant and unnecessary.

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

### RECOMMENDATIONS

- 2013-12a      Revisit the current annual report process with the aim of ensuring information is available in the most timely and efficient manner and propose revisions to the General Laws regarding the content and or timing of such information as warranted.
- 2013-12b      Consider issuing a "popular report" which readily summarizes key financial information on the System that could be a useful tool in communicating with plan members and the general public.

### Auditee Views and Corrective Action Plan:

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

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