STATE OF RHODE ISLAND

EMPLOYEES' RETIREMENT SYSTEM

FISCAL YEAR ENDED JUNE 30, 2005

Ernest A. Almonte, CPA, CFE
Auditor General

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

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE OF THE AUDITOR GENERAL

- *Integrity*
- *Reliability*
- *Independence*
- *Accountability*

February 3, 2006

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER William J. Murphy, Chairman

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

We have completed our audit of the financial statements of the Employees' Retirement System of the State of Rhode Island for the fiscal year ended June 30, 2005 in accordance with Chapter 36-8-19 of the Rhode Island General Laws.

Our report is contained herein as outlined in the Table of Contents and includes findings and recommendations intended to enhance controls over financial reporting and compliance with laws, regulations and contracts.

Sincerely,

Ernest A. Almonte, CPA, CFE
Auditor General

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND
FISCAL YEAR ENDED JUNE 30, 2005

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

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INDEPENDENT AUDITOR'S REPORT

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 accompanying basic financial statements of the Employees' Retirement System of the State of Rhode Island (the System) as of June 30, 2005 and for the year then ended, as listed in the table of contents. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1(a), the financial statements present only the Pension Trust Funds of the State of Rhode Island and Providence Plantations (the State) and do not purport to, and do not, present fairly the financial position of the State, as of June 30, 2005, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net assets of the plans within the System as of June 30, 2005, and the changes in fiduciary net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The System implemented Governmental Accounting Standards Board Statement No. 40 - *Deposit and Investment Risk Disclosures* during fiscal 2005.

In accordance with *Government Auditing Standards*, we have also issued a report dated January 27, 2006 on our consideration of the System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis beginning on page 3 and the Schedules of Funding Progress and the Schedules of Contributions from the Employers and Other Contributing Entity on pages 28 and 29 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernest A. Almonte

Ernest A. Almonte, CPA, CFE
Auditor General

January 27, 2006

Management's Discussion and Analysis

Management of the Employees' Retirement System of the State of Rhode Island (the System) provides this Management's Discussion and Analysis of their financial performance for the readers of the System's financial statements. This narrative provides an overview of the System's financial activity for the fiscal year ended June 30, 2005. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the System's financial activities based on the status of the System and issues currently facing management.

Understanding the Employees' Retirement System Financial Statements

The System administers defined benefit pension plans for state employees, teachers, state police, judges and participating municipal employees. State employees and teachers are combined in one plan while state police, judges and municipal employees each have separate plans. The *Statements of Fiduciary Net Assets* provide a snapshot of the financial position of the System at June 30, 2005. The *Statements of Changes in Fiduciary Net Assets* summarize the additions and deductions that occurred during the fiscal year. The *Notes to the Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The *Required Supplementary Information* consists of schedules and related notes, which demonstrate the System's progress in accumulating funds to meet future pension benefits for members of the System.

Financial Highlights for the Fiscal Year Ended June 30, 2005

- The System's fiduciary net assets increased by $489.9 million from $6.2 billion at June 30, 2004 to $6.7 billion at June 30, 2005.

- Total pension benefits paid to members were $564.6 million, an increase of $44.9 million or 8.65% compared to the fiscal year ended June 30, 2004.

- Total employee and employer contributions into the System's plans increased $21 million compared to the prior year. Total contributions from both employers and employees were $363 million.

- The System incurred a net gain from investing activities of $708 million for the fiscal year ended June 30, 2005. Included in this amount is $2.0 million in securities lending income.

Management's Discussion and Analysis

Assets, Liabilities and Fiduciary Net Assets (in millions)

	June 30, 2005	June 30, 2004
Assets:		
Cash and cash equivalents	$ 4.6	$ 9.5
Investments	6,700.1	6,193.8
Contributions receivable	38.2	49.7
Due from other plans	1.6	24.8
Invested securities lending collateral	1,010.6	806.5
Property and equipment	13.3	14.5
Total assets	7,768.4	7,098.8
Liabilities:		
Accounts payable	6.4	7.6
Due to other plans	1.6	24.8
Securities lending liability	1,010.6	806.5
Total liabilities	1,018.6	838.9
Net assets:	$ 6,749.8	$ 6,259.9

Summary of Changes in Fiduciary Net Assets (in millions)

	Year Ended June 30, 2005	Year Ended June 30, 2004
Additions:		
Contributions	$ 363.4	$ 342.3
Net investment gain	708.3	1,010.2
Total Additions	1,071.7	1,352.5
Deductions:		
Benefits	564.6	519.5
Refunds of contributions	10.7	7.9
Administrative expenses	6.5	5.5
Total Deductions	581.8	532.9
Increase in Fiduciary Net Assets:	489.9	819.6
Net Assets:		
Beginning of year	6,259.9	5,440.3
End of year	$ 6,749.8	$ 6,259.9

Management's Discussion and Analysis

Investments

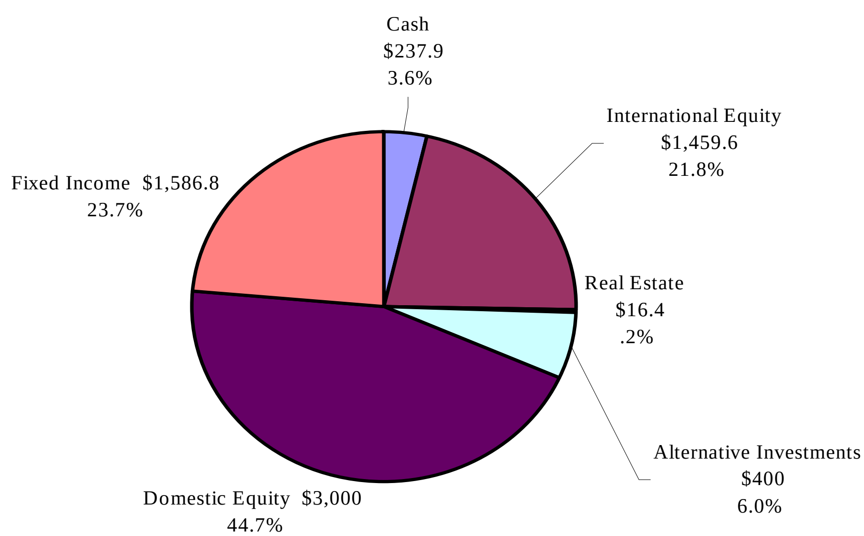
The State Investment Commission (SIC) establishes long-term asset allocation policy and monitors investment performance of the plan. An asset/liability (A/L) study is conducted every two to three years to identify an optimal diversified investment portfolio that maximizes return within an acceptable level of risk. As long-term investors, the SIC is committed to its strategic asset allocation that has been developed as part of a comprehensive A/L study which incorporates capital market return expectations, risks and correlations associated with each asset class as well as the unique profile and objectives of the System. As a defined benefit plan, the System generally has a much longer time horizon than individual investors and is better positioned to withstand short-term volatility of the capital markets.

The following asset allocation targets were in place at June 30, 2005.

Fiscal 2005 – Asset Allocation Targets	
Domestic Equity	42.5%
International Equity	20.0%
Fixed Income	25.0%
Alternative Investments	7.5%
Real Estate (1)	5.0%

(1) The real estate allocation was established in January 2003. The majority of this allocation was invested at June 30, 2005 in the domestic and international equity portfolios, which will fund approved real estate investments over time.

Asset Allocation - Actual
Fair value (in millions) at June 30, 2005



The domestic equity component includes a commingled fund, which holds fixed income securities as part of an enhanced index portfolio benchmarked to the S&P 500.

The allocation of assets among stocks, bonds and alternative investments can have a significant impact on investment performance. In light of its long time horizon, the SIC is able to take advantage of historical long-term return opportunities offered by equity investments.

Investment Performance

The System's one-year, three-year and five-year time weighted rates of return for the periods ended June 30, 2005 were 12.2%, 11.6% and 2.5%, respectively.

The international equity markets once again outperformed the U.S. equity markets during fiscal year 2005 with the Morgan Stanley Capital Investment all Country World Index (MSCI ACWI) posting a 16.9% return and the Dow Jones Wilshire 5000 Index returning 8.2% for the fiscal year ended June 30, 2005. The U.S. economy continued to demonstrate resiliency in the face of rising energy prices and higher short-term interest rates. The Federal Reserve persisted with a series of rate hikes since their initial increase last June and proceeded to raise the Fed Funds rate for the ninth time in 12 months to 3.25% on June 30th. Corporate profits continued to expand, albeit at slower rate. The bond market provided a solid return of 6.8% as measured by the Lehman Aggregate Index.

For the fiscal year ended June 30, 2005 the domestic equity portfolio was up 9.2% (vs. 6.3% for the S&P 500), the international portfolio posted a 19.0% return (vs. 16.9% for the MSCI ACWI ex US) and the fixed income composite returned 8.3% (vs. 6.8% for the Lehman Aggregate). The private equity portfolio realized a gain of 24.3% on a time-weighted total return basis for fiscal 2005 and a 41.9% internal rate of return. Since inception, the private equity composite has generated an internal rate of return of 16.0%.

The System's actuarial investment return assumption is 8.25%. Actuarial value of assets is determined based on a five-year smoothing methodology.

Funding Status

Independent actuarial valuations are conducted of the System each year. As part of this valuation, the progress toward funding pension obligations of the System is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measure is referred to as the funded ratio or funded status. As reflected in the most recent actuarial valuation (June 30, 2004), the funded ratio decreased to 59.6% for State Employees and 59.3% for Teachers within the Employees Retirement System plan. The Judges and State Police plans experienced increases in the funding ratios to 73.3% and 75.8%, respectively. The Municipal Employees Retirement System Plan's funded ratio declined with an overall ratio of 93.2%.

Management's Discussion and Analysis

During the 2005 legislative session, a law was enacted which modifies benefits under the ERS plan (State and Teachers only) for new members hired in the future and for current members who have less than 10 years of contributory service on or before July 1, 2005. The law established a new tier of benefits and new retirement eligibility requirements as follows:

- Unreduced retirement available at age 59 and 29 years of service;
- Unreduced retirement available at age 65 and 10 years of service;
- Actuarially reduced retirement available at age 55 and 20 years of service; and
- CPI-related cost-of-living adjustments up to a maximum of 3.00%

In addition, the law established a contribution re-invest provision in which any year the actuarially required employer contributions to the plan are lower than the year before, the Governor shall take 20% of the rate reduction and appropriate it to the pension fund. The actuary shall not adjust required annual contribution for the reduction; the 20% shall be in addition to required contribution and serve to reduce UAAL.

Details of the funded status of each plan within the System are included in the Schedules of Funding Progress on page 28. The law caused the ERS plan funding ratios and contribution rates to be restated as of the June 30, 2003 valuation.

All employers participating in the System's plans contributed 100% of their annual actuarially required contribution.

Economic Factors and Next Year's Contribution Rates

The System's investment portfolio experienced positive returns subsequent to June 30, 2005 consistent with the overall performance of domestic and international equity markets.

Employer contribution rates for fiscal 2006 increased for State employees (11.51% for fiscal 2005 compared to 14.84% for fiscal 2006), teachers (14.84% for fiscal 2005 compared to 16.47% for fiscal 2006), state police (28.87% for fiscal 2005 compared to 31.35% for fiscal 2006). Employer contribution rates decreased for judges (36.19% for fiscal 2005 compared to 35.51% for fiscal 2006). The fiscal 2006 employer contribution rates are based upon an actuarial valuation performed at June 30, 2003 (subsequently revised to reflect the provisions of pension reform legislation enacted during the 2005 General Assembly session).

Contacting the System's Management

This discussion and analysis presentation is designed to provide a general overview of the System's financial activity. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Employees' Retirement System, 40 Fountain Street, Providence, RI, 02903.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

Statements of Fiduciary Net Assets

As of June 30, 2005

	ERS	MERS	SPRBT	JRBT	Total *Memorandum Only*
Assets					
Cash and cash equivalents (Note 3)	$ 3,995,714	$ 189,895	$ 261,238	$ 174,550	$ 4,621,397
Receivables					
Contributions	20,114,762	2,918,918	27,547	17,901	23,079,128
Due from State for teachers	11,201,737	-	-	-	11,201,737
Due from other plans	1,255,196	337,571	-	-	1,592,767
Other	3,793,681	89,446	-	-	3,883,127
Total receivables	36,365,376	3,345,935	27,547	17,901	39,756,759
Investments at fair value (Note 3)					
Equity in short-term investment fund	15,684,243	2,925,768	-	-	18,610,011
Equity in pooled trust	5,710,023,956	905,644,193	30,170,794	19,699,922	6,665,538,865
Plan specific investments	15,984,408	-	-	-	15,984,408
Total investments before lending activities	5,741,692,607	908,569,961	30,170,794	19,699,922	6,700,133,284
Invested securities lending collateral (Note 3)	865,728,536	137,323,108	4,575,730	2,987,786	1,010,615,160
Property and equipment at cost, (net of accumulated depreciation $5,671,528 - Note 4)	11,580,054	1,706,648	30,132	19,399	13,336,233
Total Assets	6,659,362,287	1,051,135,547	35,065,441	22,899,558	7,768,462,833
Liabilities					
Securities lending liability (Note 3)	865,728,536	137,323,108	4,575,730	2,987,786	1,010,615,160
Accounts payable	5,459,215	922,227	31,745	19,263	6,432,450
Due to other plans	337,571	1,255,196	-	-	1,592,767
Total Liablilities	871,525,322	139,500,531	4,607,475	3,007,049	1,018,640,377
Net assets held in trust for pension benefits (A schedule of funding progress for each plan is presented on page 28.)	$ 5,787,836,965	$ 911,635,016	$ 30,457,966	$ 19,892,509	$ 6,749,822,456

The accompanying notes are an integral part of this financial statement.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OFRHODE ISLAND
Statements of Changes in Fiduciary Net Assets
Fiscal Year Ended June 30, 2005

	ERS	MERS	SPRBT	JRBT	Total *Memorandum Only*
Additions					
Contributions					
Member contributions	$ 133,294,091	$ 19,779,470	$ 792,410	$ 497,233	$ 154,363,204
Employer contributions	140,881,246	13,081,956	2,614,503	2,056,558	158,634,263
State contribution for teachers	48,834,755	-	-	-	48,834,755
Interest on service credits purchased	1,391,578	176,360	-	-	1,567,938
Total contributions	324,401,670	33,037,786	3,406,913	2,553,791	363,400,160
Investment income					
Net appreciation in fair value of investments	445,390,429	68,870,488	1,901,009	1,239,283	517,401,209
Interest	72,947,298	11,386,185	356,901	232,472	84,922,856
Dividends	59,764,073	9,426,245	299,668	195,160	69,685,146
Other investment income	48,286,390	7,582,482	234,557	152,390	56,255,819
	626,388,190	97,265,400	2,792,135	1,819,305	728,265,030
Less investment expense	(18,961,066)	(2,876,908)	(92,301)	(60,478)	(21,990,753)
Net investment income	607,427,124	94,388,492	2,699,834	1,758,827	706,274,277
Securities lending					
Securities lending income	17,542,062	2,782,547	92,717	60,541	20,477,867
Less securities lending expense	(15,841,653)	(2,512,826)	(83,730)	(54,672)	(18,492,881)
Net securities lending income	1,700,409	269,721	8,987	5,869	1,984,986
Total net investment income	609,127,533	94,658,213	2,708,821	1,764,696	708,259,263
Miscellaneous revenue	24,177	3,643	11	-	27,831
Total Additions	933,553,380	127,699,642	6,115,745	4,318,487	1,071,687,254
Deductions					
Benefits					
Retirement benefits	393,869,008	37,245,018	111,260	145,209	431,370,495
Cost of living adjustments	96,152,765	5,176,264	3,000	7,706	101,339,735
SRA Plus Option	26,419,588	1,291,440	-	-	27,711,028
Supplemental benefits	1,067,269	-	-	-	1,067,269
Death benefits	2,562,934	524,400	-	-	3,087,334
Total benefits	520,071,564	44,237,122	114,260	152,915	564,575,861
Refund of contributions	9,158,016	1,481,183	-	91,431	10,730,630
Administrative expense	5,390,317	995,617	39,509	25,845	6,451,288
Total Deductions	534,619,897	46,713,922	153,769	270,191	581,757,779
Net Increase	398,933,483	80,985,720	5,961,976	4,048,296	489,929,475
Net assets held in trust for pension benefits					
Beginning of year	5,388,903,482	830,649,296	24,495,990	15,844,213	6,259,892,981
End of year	$ 5,787,836,965	$ 911,635,016	$ 30,457,966	$ 19,892,509	$ 6,749,822,456

The accompanying notes are an integral part of this financial statement.

1. Plan Descriptions

(a). General

The Employees' Retirement System of the State of Rhode Island (the System) acts as a common investment and administrative agent for pension benefits to be provided for four defined benefit retirement plans as listed below:

Plan Name	*Type of Plan*
Employees' Retirement System (*ERS*)	Cost-sharing multiple-employer defined benefit plan
Municipal Employees' Retirement System (*MERS*)	Agent multiple-employer defined benefit plan
State Police Retirement Benefits Trust (*SPRBT*)	Single-employer defined benefit plan
Judicial Retirement Benefits Trust (*JRBT*)	Single-employer defined benefit plan

Although the assets of the plans are commingled for investment purposes, each plan's assets are accounted for separately and may be used only for the payment of benefits to the members of that plan, in accordance with the terms of that plan.

The System's financial statements are included as Pension Trust Funds within the Fiduciary Funds in the Comprehensive Annual Financial Report of the State of Rhode Island and Providence Plantations.

The System is administered by the State of Rhode Island Retirement Board which consists of 15 members: the general treasurer; the director of administration or his or her designee; the budget officer or his or her designee; the fiscal advisor to the house finance committee or his or her designee; the president of the league of cities and towns or his or her designee; two (2) active State employee members of the retirement system or officials from state employee unions to be elected by active State employees; two (2) active teacher members of the retirement system or officials from a teachers union to be elected by active teachers; one active municipal employee member of the retirement system or an official from a municipal employees union to be elected by active municipal employees; one retired member of the retirement system to be elected by retired members of the System; the chairperson of the house finance committee or his or her designee; the chairperson of the senate finance committee or his or her designee; and two (2) public representatives, one of whom shall be a C.L.U. competent in the area of pension benefits, shall be appointed by the governor and whose term shall be for four (4) years, or until their successors are appointed. Due to legislation know as the "Separation of Powers Act", legislative members are not active board members and the Board has not been legislatively reconstituted.

1. Plan Descriptions (continued)

The System's purpose is to provide retirement benefits to state employees, public school teachers, certain general municipal employees, public safety employees, state police officers, and judges.

A summary of membership in the plans as of the June 30, 2004 actuarial valuation is listed below:

	Retirees and beneficiaries	*Terminated plan members entitled to but not yet receiving benefits*	*Active Vested*	*Active Non-vested*	*Total by Plan*
ERS					
State Employees	9,674	2,158	8,519	4,438	24,789
Teachers	8,179	1,836	7,001	7,555	24,571
MERS					
General Employees	3,419	1,719	2,821	4,245	12,204
Public Safety	346	65	602	633	1,646
SPRBT	1	1	-	148	150
JRBT	2	-	4	40	46
Total by type	21,621	5,779	18,947	17,059	63,406

(b). Membership and Benefit Provisions

(1) Employees' Retirement System (ERS)

The ERS was established under section two of chapter 2334 of the Rhode Island Public Laws of 1936 and placed under the management of the Retirement Board for the purpose of providing retirement allowances for employees of the State of Rhode Island under the provisions of chapters 8 to 10, inclusive, of title 36, and public school teachers under the provisions of chapters 15 to 17, inclusive, of title 16 of the Rhode Island General Laws.

The plan covers most State employees other than certain personnel at the State colleges and university (principally faculty and administrative personnel). Elected officials may become members on an optional basis. Membership in the plan is compulsory for teachers, including superintendents, principals, school nurses, and certain other school officials in the public schools in the cities and towns. Rhode Island Airport Corporation (RIAC) employees hired before July 1, 1993 are also covered and have the same benefits as State employees. Rhode

1. Plan Descriptions (continued)

Island Economic Development Corporation (RIEDC) employees who were (1) active contributing members and employees of the Department of Economic Development of the State of Rhode Island before October 31, 1995, and (2) elected to continue membership in the plan are also covered and have the same benefits as State employees. Narragansett Bay Water Quality District Commission employees who are members of a collective bargaining unit are also covered and have the same benefits as State employees.

The plan provides unreduced benefits of 1.7% of earnings for each of the first ten years of service; 1.9% for each of the next ten years; 3.0% per year for each of the next fourteen years; and 2% for the 35th year. Joint and survivor options are available as well as the Service Retirement Allowance (SRA) Plus option that provides for the payment of a larger benefit before the attainment of age sixty-two (62) and a reduced amount thereafter. The reduced amount is equal to the benefit before age sixty-two (62), including cost-of-living increases, minus the member's estimated social security benefit payable at age sixty-two (62). The maximum benefit is 80% of final average earnings after 35 years of service. Such benefits are available to members at least age 60 with 10 years of service, or after 28 years at any age. A different benefit formula applies to State correctional officers who may retire at age 50 if they have 20 years of service. Benefits for all employees are based on the average of the highest three consecutive years' earnings, exclusive of overtime.

On the third January after retirement, a cost-of-living increase of 3% (compounded annually) is provided independent of actual changes in the consumer price index. The plan also provides nonservice-connected disability benefits after five years of service; service-connected disability pensions with no minimum service requirement; vested benefits after ten years of service; survivor's benefits for service-connected death; and certain lump sum death benefits.

The plan also provides benefits to legislators elected to office prior to January 1, 1995, of $600 for every year served up to a maximum of $12,000. Such benefits are available to legislators 55 and over with at least 8 years of service or, at any age with 20 or more years of service.

Effective July 1, 2005, the law was amended to modify benefits under the ERS plan (State and Teachers only) for new members hired in the future and for current members who have less than 10 years of contributory service on or before July 1, 2005. These members are referred to as Schedule B members. For Schedule B members, the plan provides unreduced benefits of 1.6% of earnings for each of the first ten years of service; 1.8% for each of the next ten years; 2.0% per year for years 21 through 25 inclusive; 2.25% per year for years 26 through 30 inclusive; 2.50% per year for years 31 through 37 inclusive and 2.25% for the 38th year. Only single life, and joint and survivor options are available. The maximum benefit is 75% of his or her average highest three (3) years of compensation after 38 years of service. Such benefits are available to members at least age 65 with 10 years of service, or after 29 years of service and age 59. Actuarially reduced retirement is available at age 55

1. Plan Descriptions (continued)

and 20 years of service, the benefit is reduced actuarially for each month that the age of the member is less than sixty-five (65) years.

On the month following the third anniversary date of the retirement, and on the month following the anniversary date of each succeeding year, a cost-of-living increase of 3% (compounded annually) or the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U) as published by the United States Department of Labor Statistics, determined as of September 30 of the prior calendar year, whichever is less is provided for Schedule B members.

The plan provides a survivor benefit to public school teachers via a "Teachers Survivor Benefits Fund" in lieu of Social Security. Not all school districts participate in the plan. 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 city, town, or school district by which the member is employed. These contributions are in addition to the contributions required for regular pension benefits.

Spouse, parents, family and children's benefits are payable following the death of a member. A spouse shall be entitled to benefits upon attaining the age of sixty (60) years. Children's benefits are payable to the child, including a stepchild or adopted child of a deceased member if the child is unmarried and under the age of eighteen (18) years or twenty-three (23) years and a full time student, and was dependent upon the member at the time of the member's death. Family benefits are provided if at the time of the member's death the surviving spouse has in his or her care a child of the deceased member entitled to child benefits. Parents benefits are payable to the parent or parents of a deceased member if the member did not leave a widow, widower, or child who could ever qualify for monthly benefits on the member's wages and the parent has reached the age of 60 years, has not remarried, and received support from the member. In January, a yearly cost-of-living adjustment for spouse's benefits is paid and based on the annual social security adjustment.

The Teachers Survivor Benefits Fund provides benefits based on the highest salary at the time of retirement of the teacher. Benefits are payable in accordance with the following table:

Highest Annual Salary	Spousal Monthly Minimum Benefit
$17,000 or less	$ 750
$17,001 to $25,000	$ 875
$25,001 to $33,000	$ 1,000
$33,001 to $40,000	$ 1,125
$40,001 and over	$ 1,250

1. Plan Descriptions (continued)

Benefits payable to children and families are equal to the spousal benefit multiplied by the percentage below:

Parent and 1 Child	Parent and 2 Children	Parent and more than 2 Children	One Child Alone	Two Children Alone	Three or more Children Alone
150%	175%	175%	75%	150%	175%

(2) Municipal Employees' Retirement System (MERS)

The MERS was established under section one of chapter 2784 of the Rhode Island Public Laws of 1951 and placed under the management of the Retirement Board for the purpose of providing retirement allowances to employees of municipalities, housing authorities, water and sewer districts, and municipal police and fire persons that have elected to participate.
The plan generally provides retirement benefits equal to 2% of a member's final average salary multiplied by the number of years of total service up to a maximum of 75%. Joint and survivor options are available as well as the Service Retirement Allowance (SRA) Plus option that provides for the payment of a larger benefit before the attainment of age sixty-two (62) and a reduced amount thereafter. The reduced amount is equal to the benefit before age sixty-two (62), including cost-of-living increases, minus the member's estimated social security benefit payable at age sixty-two (62). Such benefits are available to members at least age 58 with 10 years of service or after 30 years of service at any age. Police and fire personnel may retire at age 55 if they have 10 years of service or after 25 years of service at any age. An optional cost-of-living provision may be elected for police and fire personnel and general employees. An option may be elected to provide a 20 year service pension with a benefit equal to 2.5% for each year of service up to a maximum of 75% for police and fire personnel. Benefits are based on the average of the highest three consecutive years' earnings, exclusive of overtime.

The plan also provides nonservice-connected disability benefits after 5 years of service; service-connected disability pensions with no minimum service requirement; vested benefits after 10 years of service; survivor's benefits; and certain lump sum death benefits. A summary of participating employers is listed below:

Municipalities, housing authorities, water and sewer districts	68
Municipal police and fire departments	46
Total participating units as of the actuarial valuation at June 30, 2004	114

(3) State Police Retirement Benefits Trust (SPRBT)

The State Police Retirement Benefits Trust was established under Rhode Island General Law Section 42-28-22.1 and was placed under the management of the Retirement Board for the purpose of providing retirement allowances to State Police.

1. Plan Descriptions (continued)

The plan covers all State Police and Superintendents hired after July 1, 1987.

The plan generally provides retirement benefits equal to 50% of final salary after 20 years of service, plus 3.0% of final salary times service in excess of 20 years through 25 years to a maximum of 65% of final salary. Such benefits are available to members after 20 years of service regardless of age. The Superintendent of the State Police will receive 50% of his/her final salary and may retire after attainment of age 60 and 10 years of service. A cost-of-living adjustment of $1,500 per annum beginning on January 1st of the year in which a member attains his/her third anniversary of retirement is provided to all members. Benefits are based on the final base salary earned at retirement including longevity increment, holiday pay, clothing allowance and up to 400 overtime hours.

The plan also provides nonservice-connected disability benefits after 10 years of service and service-connected disability pensions with no minimum service requirement.

(4) Judicial Retirement Benefits Trust (JRBT)

The Judicial Retirement Benefits Trust was established under Rhode Island General Laws 8-8.2-7; 8-3-16; 8-8-10.1; 28-30-18.1; and was placed under the management of the Retirement Board for the purpose of providing retirement allowances to Justices of the Traffic Tribunal, Supreme, Superior, Family, District and Workers Compensation courts.

The plan covers all Judges appointed after December 31, 1989.

The plan generally provides retirement benefits equal to 75% of the final salary at the time of retirement after 20 years of service, or 10 years of service and attainment of age 65. For judges appointed subsequent to July 2, 1997, salary is the average highest three (3) consecutive years of compensation. Judges retiring after 20 years of service after age 65 or 15 years of service after age 70 will receive full retirement benefits, which is the final salary at time of retirement. For judges appointed subsequent to July 2, 1997, salary is the average highest three (3) consecutive years of compensation. On the third January after the date of retirement, a cost-of-living increase amounting to 3% not compounded is provided to Supreme, Superior, Family and District Court Judges, independent of actual changes in the consumer price index. Traffic Tribunal and Workers' Compensation Court Judges, on the third January after the date of retirement, receive a cost-of-living increase amounting to 3% compounded annually.

2. Summary of Significant Accounting Policies

These financial statements were prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The Governmental Accounting Standards Board (GASB) is responsible for establishing generally accepted accounting principles for defined benefit pension plans established by governmental entities. In accordance with GASB Statement No. 20, in the absence of specific guidance from a GASB pronouncement, pronouncements of the Financial Accounting Standards Board (FASB) issued on or before November 30, 1989 have been followed.

Basis of Accounting - The financial statements of the System are prepared on the accrual basis of accounting. Under this method revenues are recorded when earned and expenses are recorded when incurred. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to each plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan. Dividend income is recorded on the ex-dividend date. Investment transactions are recorded on a trade date basis. The gains or losses on foreign currency exchange contracts are included in income in the period in which the exchange rates change. Gains and losses on contracts which hedge specific foreign currency denominated commitments are deferred and recognized in the period in which the transaction is completed.

Method Used to Value Investments - Investments are recorded in the financial statements at fair value. Fair value is the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller - that is, other than a forced liquidation sale. The fair value of fixed income and domestic and international stocks is generally based on published market prices and quotations from national security exchanges and securities pricing services. Real estate is primarily valued on appraisals by independent appraisers or as adjusted by the general partner. Commingled funds consist primarily of institutional equity index funds. The fair value of the commingled funds is based on the reported share value of the respective fund. Futures contracts are valued at the settlement price established each day by the board of trade or exchange on which they are traded. Short-term investments are stated at cost which approximates fair value. Other investments that are not traded on a national security exchange are valued based on audited December 31 net asset values adjusted for purchases, sales, and cash flows for the period January 1 to June 30.

Cash and Cash Equivalents - Cash represents cash held in trust in a financial institution. Cash equivalents are highly liquid investments with a maturity of three months or less at the time of purchase.

2. Summary of Significant Accounting Policies (continued)

Property and Equipment – These assets represent the Line of Business System and computer equipment recorded at cost. Depreciation is provided on a straight-line basis over the estimated useful lives, ten and five years respectfully. Depreciation of the Line of Business System commences as each stage is implemented. Property, plant and equipment is allocated to each plan based on its proportionate share of net assets.

Memorandum Only - Total Columns - Total columns on the financial statements are captioned "memorandum only" to indicate that they are presented only to facilitate financial analysis. Data in these columns are not comparable to a consolidation. Inter-fund eliminations have not been made in the aggregation of this data.

Adoption of New Accounting Standard – The System implemented Governmental Accounting Standards Board Statement No. 40 – *Deposit and Investment Risk Disclosures* during fiscal 2005.

3. Cash Deposits and Investments

(a). Cash Deposits and Cash Equivalents

At June 30, 2005, the carrying amounts of the plans' cash deposits are listed below:

	ERS	MERS	SPRBT	JRBT
Book balance	$3,995,714	$189,895	$261,238	$174,550
Bank balance	$3,820,845	$538,445	$262,756	$175,587

The bank balances represent the plans' deposits in short-term trust accounts that are covered by federal depository insurance. At the end of each business day, the excess bank balances are invested in overnight repurchase agreements. The book and bank balances include fully collateralized deposits of $99,151 and overnight repurchase agreements of $1,179,382 which were fully collateralized.

In accordance with Rhode Island General Law Chapter 35-10.1, depository institutions holding deposits of the State, its agencies or governmental subdivisions of the State shall, at a minimum, insure or pledge eligible collateral equal to one hundred percent of time deposits with maturities greater than sixty days. Any of these institutions that do not meet minimum capital standards prescribed by federal regulators shall insure or pledge eligible collateral equal to one hundred percent of deposits, regardless of maturity. None of the System's deposits were required to be collateralized at June 30, 2005.

3. Cash Deposits and Investments (continued)

(b). Investments

The State Investment Commission oversees all investments made by the State of Rhode Island, including those made for the System. Investment managers engaged by the Commission, at their discretion and in accordance with the investment objectives and guidelines for the System, make certain investments. The General Treasurer makes certain short-term investments on a daily basis. Rhode Island General Law Section 35-10-11 (b)(3) requires that all investments shall be made in securities as would be acquired by prudent persons of discretion and intelligence who are seeking a reasonable income and the preservation of capital.

On July 1, 1992, the State Investment Commission pooled the assets of the ERS with the assets of the MERS for investment purposes only, and assigned units to the plans based on their respective share of market value. On September 29, 1994 and November 1, 1995, the assets of the SPRBT and the JRBT, respectively, were added to the pool for investment purposes only. The custodian bank holds most assets of the System in two pooled trusts, Short-term Investment Trust and Pooled Trust. Each plan holds units in the trusts. The number of units held by each plan is a function of each plans' respective contributions to, or withdrawals from, the trust. Certain investments are not pooled and are held by only one plan (Plan specific investments). As of June 30, 2005, the ERS held a loan receivable with a fair value of $15,000,000. This loan is secured by commercial real estate located in Rhode Island (see note 8 - Subsequent Events).

The following table presents the fair value of investments by type at June 30, 2005:

Investment Type:		Fair Value
U.S Government Securities	$	539,402,733
U.S Government Agency Securities		415,812,970
Collateralized Mortgage Obligations		75,624,668
Corporate Bonds		508,771,403
International Corporate Bonds		47,195,265
Domestic Equity Securities		1,211,576,466
International Equity Securities		1,303,428,803
Foreign Currencies		12,758,503
Private Equity		399,941,947
Real Estate		16,350,658
Money Market Mutual Fund		237,860,402
Commingled Funds - Domestic Equity		1,788,278,914
Commingled Funds - International Equity		143,130,552
Investments at Fair Value	$	6,700,133,284
Securities Lending Collateral Pool		1,010,615,160
Total	$	7,710,748,444

3. Cash Deposits and Investments (continued)

(c). Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

Duration is a measure of a debt security's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The System manages its exposure to interest rate risk by comparing each debt security manager portfolio's effective duration against a predetermined benchmark index based on that manager's mandate. Currently each portfolio's duration must be within +/- 20-35% of the effective duration of the appropriate index. The fixed income indices currently used by the System are:

- Salomon Brothers Broad Investment Grade Bond Index
- Lehman US TIPS Index
- Lehman Brothers MBS Fixed Rate Index
- CS First Boston High Yield Index
- Lehman Corporate Index

At June 30, 2005, no fixed income manager was outside of the policy guidelines.

The following table shows the System's fixed income investments by type, fair value and the effective durations at June 30, 2005:

Investment Type:	Fair Value	Effective Duration
U.S. Government Securities	$ 539,402,733	5.18
U.S. Government Agency Securities	415,812,970	2.56
Collateralized Mortgage Obligations	75,624,668	2.92
Corporate Bonds	508,771,403	4.24
International Corporate Bonds	47,195,265	7.96
Total	$1,586,807,039	4.21

The System also invested in a short-term money market mutual fund that held investments with an average maturity of 29 days. The maximum maturity of any instrument in the money market mutual fund is 13 months.

3. Cash Deposits and Investments (continued)

The System invests in various mortgage-backed securities, such as collateralized mortgage obligations (CMO), interest-only and principal-only (PO) strips. They are reported in aggregate as U.S. Government and Agency Securities in the disclosure of custodial credit risk. CMO's are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes or tranches in accordance with the CMO's established payment order. Some CMO tranches have more stable cash flows relative to changes in interest rates while others are significantly sensitive to interest rate fluctuations. The System may invest in interest-only (IO) and principal-only strips (PO) in part to hedge against a rise in interest rates. Interest-only strips are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to pre-payments by mortgagees, which may result from a decline in interest rates. Principal-only strips receive principal cash flows from the underlying mortgages. In periods of rising interest rates, homeowners tend to make fewer mortgage prepayments.

(d). Credit Risk

The System requires its fixed income managers to maintain a well-diversified portfolios by sector, credit rating and issuer.

The System directs its investment managers to maintain diversified portfolios by sector and by issuer using the prudent person standard, which is the standard of care employed solely in the interest of the participants and beneficiaries of the funds and for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the funds. Each manager's portfolio composition is aligned with a benchmark and is constructed based on specific guidelines that are reflective of the manager's mandate. An example of a high yield fixed income manager is as follows:

- No single industry is expected to represent more than 20% of the portfolio's market value.
- No single issue is expected to represent more than 5% of the portfolio's market value.
- The portfolio, once fully invested, is expected to include a minimum of 70 individual holdings.
- The portfolio quality is expected to be invested in high yield below investment grade fixed income securities.
- The weighted average credit quality is expected to maintain a minimum rating of "B" using either Moody's or Standard and Poor's credit ratings.

3. Cash Deposits and Investments (continued)

The System's exposure to credit risk as of June 30, 2005 is as follows:

Quality Rating [1]	Collateralized Mortgage Obligations	U.S. Government Agency Securities	Corporate Bonds	International Corporate Bonds
Aaa	$ 40,080,560	$ 415,812,970	$ 20,020,703	$ 8,232,524
Aa	7,058,265		44,715,106	8,769,972
A	5,583,468		119,802,524	14,513,724
Baa	1,879,816		109,031,387	5,941,676
Ba			44,476,476	2,247,844
B			123,469,375	6,071,446
Caa			33,386,847	455,300
Ca			672,050	
Not rated	21,022,559		13,196,935	962,779
Fair Value	$ 75,624,668	$ 415,812,970	$ 508,771,403	$ 47,195,265

[1] **Moody's bond ratings**

The System's investment in a short-term money market mutual fund was unrated but held investments with an average quality rating of A-1+ / P-1.

(e). Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a System's investments in a single issuer. There is no single issuer exposure within the System's portfolio that comprises 5% of the overall portfolio and, therefore, there is no concentration of credit risk.

(f). Custodial Credit Risk

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. At June 30, 2005 all securities were registered in the name of the System and were held in the possession of the System's custodial bank, State Street Bank and Trust.

3. Cash Deposits and Investments (continued)

(g). Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. Portfolios are diversified to limit foreign currency and security risk and The System's investment asset allocation policy targets non-US equity investments at 20%. The System may enter into foreign currency exchange contracts to minimize the short-term impact of foreign currency fluctuations on foreign investments.

The System's exposure to foreign currency risk at June 30, 2005, was as follows:

Currency	Currency	Equities	Fixed Income	Total
Australian Dollar	$ 419,302	$ 82,681,552	$	$ 83,100,854
Brazilian Real			4,625,000	4,625,000
Canadian Dollar	258,815	49,125,148	4,556,171	53,940,134
Danish Krone	53,927	4,156,678		4,210,605
Euro Currency	1,565,504	491,786,448	33,721,974	527,073,926
Hong Kong Dollar	155,633	26,306,854		26,462,487
Hungarian Forint	129	357,751		357,880
Indonesian Rupiah	166,696	2,176,811		2,343,507
Japanese Yen	1,606,859	256,658,123		258,264,982
Malaysian Ringitt			781,282	781,282
Mexican Peso	15,216	222,300	695,248	932,764
New Zealand Dollar	15,379	10,293,925		10,309,304
Norwegian Krone	22,456	14,616,209		14,638,665
Pound Sterling	2,616,148	250,934,267	1,998,090	255,548,505
Singapore Dollar	273,389	17,238,859		17,512,248
South African Rand	579,747	7,021,862		7,601,609
South Korean Won	1,251,662	14,293,544		15,545,206
Swedish Krona	3,507,676	18,415,703	817,500	22,740,879
Swiss Franc	249,965	54,897,946		55,147,911
New Taiwan Dollar		2,244,823		2,244,823
Total	$ 12,758,503	$ 1,303,428,803	$ 47,195,265	$ 1,363,382,571

The System also had exposure to foreign currency risk though its investment in an international commingled equity fund.

3. Cash Deposits and Investments (continued)

(h). Derivatives and Other Similar Investments

Some of the System's investment managers are allowed to invest in certain derivative type transactions, including forward foreign currency transactions, futures contracts and mortgage-backed securities. According to investment policy guidelines, derivative type instruments may be used for hedging purposes and not for leveraging plan assets.

Forward Foreign Currency Contracts – The System may enter into foreign currency exchange contracts to minimize the short-term impact of foreign currency fluctuations on foreign investments. These contracts involve risk in excess of the amount reflected in the System's Statements of Fiduciary Net Assets. The face or contract amount in U.S. dollars reflects the total exposure the System has in that particular currency contract. By policy, no more than 25% of actively managed Foreign Equity securities (at fair value) may be hedged into the base currency (US Dollars). The U.S. dollar value of forward foreign currency contracts is determined using forward currency exchange rates supplied by a quotation service. Losses may arise due to changes in the value of the foreign currency or if the counterparty does not perform under the contract.

Futures contracts – The System may use futures to manage its exposure to the stock, money market, and bond markets and the fluctuations in interest rates and currency values. Buying futures tends to increase the System's exposure to the underlying instrument. Selling futures tends to decrease the System's exposure to the underlying instrument, or hedge other System investments. Losses may arise from changes in the value of the underlying instruments, if there is an illiquid secondary market for the contracts, or if the counterparties do not perform under the contract terms.

Through commingled funds, the System also indirectly holds derivative type instruments, primarily equity index futures. Other types of derivative type instruments held by the commingled funds include purchased or written options, forward security contracts, forward foreign currency exchange contracts, interest rate swaps and total return swaps.

The System may sell a security they do not own in anticipation of a decline in the fair value of that security. Short sales may increase the risk of loss to the System when the price of a security underlying the short sale increases and the System is subject to a higher cost to purchase the security in order to cover the position.

3. Cash Deposits and Investments (continued)

(i). Securities Lending

Policies of the State Investment Commission permit the System to enter into securities lending transactions. The System has contracted with State Street Bank & Trust Company (SSB) as third party securities lending agent to lend the System's debt and equity securities for cash, securities and sovereign debt of foreign countries as collateral at not less than 100% of the market value of the domestic securities on loan and at not less than 100% of the market value of the international securities on loan. In practice, U.S. equities and bonds are collateralized at 102% and international equities are collateralized at 105%. There are no restrictions on the amount of loans that can be made. The contract with the lending agent requires them to indemnify the System if the borrowers fail to return the securities. Either the System or the borrower can terminate all securities loans on demand. The cash collateral received on security loans was invested in the lending agent's short-term investment pool for an average duration of 25 days and a weighted average maturity of 174 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. The System is not permitted to pledge or sell collateral securities received unless the borrower defaults. There were no losses during the fiscal year resulting from default of the borrowers or lending agent.

At June 30, 2005, management believes the System has no credit risk exposure to borrowers because the amounts the System owes the borrowers do not exceed the amounts the borrowers owe the System. The securities on loan at year-end were $988,765,048 (fair value), and the collateral received for those securities on loan was $1,017,104,074 (fair value).

4. Property and Equipment

Property and equipment consist of the line of business system and computer equipment at historical cost. Balances at June 30, 2005 were:

	ERS	MERS	SPRBT	JRBT	Total
Line of Business System	$ 15,868,188	$ 2,336,400	$ 40,254	$ 25,922	$ 18,270,764
Equipment	$ 641,268	$ 93,634	$ 1,271	$ 824	$ 736,997
Total	$ 16,509,456	$ 2,430,034	$ 41,525	$ 26,746	$ 19,007,761
Accumulated Depreciation	4,929,402	723,386	11,393	7,347	5,671,528
Net Property and Equipment	$ 11,580,054	$ 1,706,648	$ 30,132	$ 19,399	$ 13,336,233

5. Contributions

Contribution requirements for plan members and employers are established pursuant to Rhode Island General Laws. Employers are required to contribute at an actuarially determined rate. Plan member contributions are fixed by statute.

(a). Funding Policy

The funding policies, as set forth in Rhode Island General Law, Section 36-10-2 and 45-21-42 provide for actuarially determined periodic contributions to the plans. The actuarial valuation uses the Entry Age Normal actuarial cost method. Under this method, the employer contribution rate is the sum of (i) the employer normal cost rate, and (ii) a rate that will amortize the unfunded actuarial liability. The valuation is prepared on the projected benefit basis, under which the present value, at the assumed rate of return (currently 8.25 percent), of each participant's expected benefit payable at retirement or death is determined, based on age, service, gender and compensation.

The employer contributions required to support the benefits of the Plan are determined following a level funding approach, and consist of a normal contribution and an accrued liability contribution. The normal contribution is determined using the "entry age normal" method. Under this method, a calculation is made to determine the average uniform and constant percentage rate of employer contribution which, if applied to the compensation of each new participant during the entire period of his anticipated covered service, would be required in addition to the contributions of the participant to meet the cost of all benefits payable on his behalf. The unfunded accrued liability contributions are determined by subtracting the actuarial value of assets from the actuarial accrued liability and amortizing the result over a period not to exceed 30 years from June 30, 1999.

Effective July 1, 2005, the law as amended requires, in addition to the contributions provided for by the funding policy, commencing in fiscal year 2006, and each year thereafter, for each fiscal year in which the actuarially determined state contribution rate for state employees and teachers is lower than that for the prior fiscal year, the governor shall include an appropriation to that system equivalent to twenty percent (20%) of the rate reduction to be applied to the actuarial accrued liability. The amounts to be appropriated shall be included in the annual appropriation bill and shall be paid by the general treasurer into the retirement system. The retirement system's actuary shall not adjust the computation of the annual required contribution for the year in which supplemental contributions are received; such contributions once made may be treated as reducing the actuarial liability remaining for amortization in the next following actuarial valuation to be performed.

5. Contributions (continued)

(b). Contributions

Employer contribution rates for fiscal 2005 were developed based on an actuarial valuation performed as of June 30, 2002. The table below displays the contribution rates for the year ending June 30, 2005:

Plan	Employee	Employer
ERS		
State Employees	8.75%	11.51%
Teachers	9.50%	
Municipal funded		8.72% (*7.99% for towns not participating in the 1990 early retirement incentive*)
State funded		6.12% (*5.62% for towns not participating in the 1990 early retirement incentive*)
MERS		
General Employees	6.00% (additional 1% with a cost-of-living adjustment)	68 Municipalities, housing authorities, water and sewer districts contributed various actuarially determined rates.
Public Safety	7.00% (additional 1% with a cost-of-living adjustment and /or 1% with a 20 year service plan), Cranston Police and Cranston Fire are contributing 10% due to special plan provisions	46 Municipal police and fire departments contributed various actuarially determined rates.
SPRBT	8.75%	28.87%
JRBT	8.75%	36.19%

6. Administrative Expenses

Pursuant to General Law section 36-8-10.1, administrative costs of the System are financed through investment earnings up to a maximum of .175% of the average total investments before lending activities as reported in the annual report of the Auditor General for the next preceding five (5) fiscal years. Such amounts are transferred to a restricted receipt account within the State's general fund. Any unencumbered funds on June 30 of any fiscal year are credited to the plans in the same proportion as their contributions to the restricted receipt account.

7. Post-Employment Health Care Benefits

In accordance with the General Laws, post-employment health care benefits are provided to State employee members of the ERS plan who retire on or after July 1, 1989. The benefits in general cover medical and hospitalization costs for pre-Medicare retirees and a Medicare supplement for Medicare eligible retirees. The State's share of the costs of these benefits ranges from 50% for retirees with 10-15 years of service to 100% for retirees with 35 years of service. These benefits are provided on a pay-as-you-go basis and are not accounted for as part of the Employees' Retirement System. The financial activity related to post-employment benefits for state employees is reflected in the State's general fund.

8. Subsequent Events

In November 2005, the System obtained title to commercial real estate located in Providence, Rhode Island as a result of bankruptcy foreclosure proceedings in the U.S. Bankruptcy Court. The System held a first lien on the commercial real estate owned by an obligor of a mortgage loan receivable held as a plan specific investment. The mortgage loan receivable is guaranteed by the Rhode Island Economic Development Corporation (RIEDC) to the extent of $3 million. The System has requested payment of the guarantee by RIEDC. In January 2006, the System leased the premises to a corporation pursuant to a 3-year operating lease.

Employees' Retirement System of the State of Rhode Island

Required Supplementary Information

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

REQUIRED SUPPLEMENTARY INFORMATION

Schedules Of Funding Progress

Actuarial Valuation Date		Actuarial Value of Assets (a)	** Actuarial Accrued Liability (AAL) - Entry Age - (b)	*** Unfunded AAL (UAAL) (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
ERS (*State Employees*)							
6/30/2004		$ 2,202,900,345	$ 3,694,787,818	$ 1,491,887,473	59.6%	$ 606,087,585	246.2%
6/30/2003	±	2,267,673,016	3,517,352,031	1,249,679,015	64.5%	606,102,182	206.2%
6/30/2002		2,353,855,871	3,284,126,961	930,271,090	71.7%	586,888,754	158.5%
6/30/2001		2,406,278,029	3,089,247,738	682,969,709	77.9%	539,015,218	126.7%
6/30/2000		2,345,319,663	2,874,905,547	529,585,884	81.6%	517,632,152	102.3%
6/30/1999	*	2,201,890,748	2,607,397,329	405,506,581	84.4%	494,815,513	82.0%
ERS (*Teachers*)							
6/30/2004		$ 3,340,527,073	$ 5,634,195,435	$ 2,293,668,362	59.3%	$ 866,532,598	264.7%
6/30/2003	±	3,427,685,554	5,341,627,416	1,913,941,862	64.2%	834,642,391	229.3%
6/30/2002		3,553,823,995	4,857,003,061	1,303,179,066	73.2%	792,015,577	164.5%
6/30/2001		3,619,863,426	4,679,288,010	1,059,424,584	77.4%	748,460,527	141.5%
6/30/2000		3,514,399,312	4,359,881,262	845,481,950	80.6%	703,201,056	120.2%
6/30/1999	*	3,259,015,814	3,967,529,172	708,513,358	82.1%	673,484,467	105.2%
SPRBT							
6/30/2004		$ 24,767,014	$ 32,689,173	$ 7,922,160	75.8%	$ 11,421,880	69.4%
6/30/2003		20,966,294	28,443,717	7,477,423	73.7%	11,286,365	66.3%
6/30/2002		17,770,149	23,527,125	5,756,976	75.5%	10,933,360	52.7%
6/30/2001		14,386,064	16,649,820	2,263,756	86.4%	9,139,418	24.8%
6/30/2000		11,336,596	13,917,343	2,580,747	81.5%	8,916,914	28.9%
6/30/1999	*	8,480,657	10,841,544	2,360,887	78.2%	7,502,433	31.5%
JRBT							
6/30/2004		$ 16,019,053	$ 21,845,744	$ 5,826,691	73.3%	$ 5,637,865	103.3%
6/30/2003		13,270,977	18,435,395	5,164,418	72.0%	5,303,153	97.4%
6/30/2002		11,129,208	16,243,709	5,114,501	68.5%	4,738,059	107.9%
6/30/2001		9,190,325	12,026,257	2,835,932	76.4%	4,092,423	69.3%
6/30/2000		7,374,851	9,719,608	2,344,757	75.9%	3,533,354	66.4%
6/30/1999	*	5,521,693	7,415,237	1,893,544	74.5%	3,169,183	59.7%
MERS							
6/30/2004		$ 879,449,653	$ 943,536,048	$ 64,086,395	93.2%	$ 258,985,220	24.7%
6/30/2003		885,842,533	879,589,065	(6,253,468)	100.7%	241,201,031	(2.6)%
6/30/2002		907,193,399	814,857,497	(92,335,902)	111.3%	247,613,063	(37.3)%
6/30/2001		895,475,425	758,089,758	(137,385,667)	118.1%	225,827,136	(60.8)%
6/30/2000		885,392,216	710,616,311	(174,775,905)	124.6%	207,834,738	(84.1)%
6/30/1999		805,493,262	635,863,479	(169,629,783)	126.7%	191,234,546	(88.7)%

See notes to required supplementary information.

***** Restated numbers based on Entry Age Normal funding method

± Restated June 30, 2003 actuarial accrued liability due to the adoption of Article 7, Substitute A as Amended

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

REQUIRED SUPPLEMENTARY INFORMATION

Schedules Of Contributions From The Employers
And Other Contributing Entity

ERS

Fiscal Year Ended June 30	State Employees Annual Required Contribution	State Employees Percentage Contributed	Teachers (State) Annual Required Contribution	Teachers (State) Percentage Contributed	Teachers (Employers) Annual Required Contribution	Teachers (Employers) Percentage Contributed
2005	$ 66,087,984	100%	$ 48,834,755	100%	$ 73,006,173	100%
2004	55,699,588	100%	45,039,279	100%	70,666,221	100%
2003	45,141,250	100%	38,242,690	100%	55,504,739	100%
2002	31,801,645	100%	30,763,337	100%	44,391,050	100%
2001	44,540,998	100%	35,365,234	100%	48,153,386	100%
2000	44,353,675	100%	40,719,407	100%	57,667,528	100%

MERS

Fiscal Year Ended June 30	Annual Required Contribution	Percentage Contributed
2005	13,081,956	100%
2004	9,406,147	100%
2003	6,485,065	100%
2002	7,536,081	100%
2001	6,092,688	100%
2000	5,823,861	100%

SPRBT

Fiscal Year Ended June 30	Annual Required Contribution	Percentage Contributed
2005	2,614,503	100%
2004	2,224,191	100%
2003	2,256,770	100%
2002	2,405,041	100%
2001	1,819,930	100%
2000	1,508,778	100%

JRBT

Fiscal Year Ended June 30	Annual Required Contribution	Percentage Contributed
2005	2,056,558	100%
2004	1,830,204	100%
2003	1,656,965	100%
2002	1,458,093	100%
2001	1,163,571	100%
2000	1,007,618	100%

See notes to required supplementary information.

1. Schedules of Funding Progress

Effective with the June 30, 2003 valuation, material changes were made to the termination, payroll growth and salary increase assumptions. Changes were also made to the general mortality rates and mortality rates used for disabled lives. The disability and retirement tables were also adjusted to reflect the plan experience. Particularly, the salary increase rates for state employees were changed from 4.25% - 14.25% to 4.5% - 8.25%. The base salary increase rates were increased from 4.25% to 4.5% for all teachers and MERS General Employees, and decreased from 5.5% to 5.25% for Judges. The payroll growth rate was increased from 3.0% to 3.75% for ERS, MERS and State Police and decreased from 5.5% to 5.25% for Judges. The June 30, 2003 actuarial accrued liability was restated to reflect the amendment to the law governing benefits for state employees and teachers effective July 1, 2005 – see note 1(b) to the financial statements entitled *Plan Descriptions – Membership and Benefit Provisions*.

Effective with the June 30, 2002 valuation, the amortization period for the unfunded actuarial accrued liability for MERS was changed to 30 years from June 30, 1999 or 27 years from June 30, 2002.

Effective with the June 30, 2002 valuation, the actuarial value of assets for MERS was changed from a three-year smoothed market technique to a five-year smoothed market technique.

Effective with the June 30, 1999 valuation, which was restated, certain actuarial assumptions were changed. Specifically, the actuarial cost method for ERS, SPRBT and JRBT were set to Entry Age Normal and the amortization period was changed to 30 years. The inflation assumption was decreased from 3.5% to 3.0%.

Effective with the June 30, 1999 valuation, the actuarial value of assets was developed using a five-year smoothed market technique for ERS, SPRBT and JRBT.

The MERS funded ratio is a composite of all units in the plan. The System performs a separate valuation for each unit.

2. Schedules of Employer Contributions

Employer contributions for the ERS plan included in the Schedules of Contributions from the Employers and Other Contributing Entity do not include Teacher Survivor Benefits as described in Note 1(b) and any employer contributions related to supplemental pension benefits that are attributable and paid by a specific employer. These amounts are not included in the annual required contribution.

The Plans began using the entry age normal cost method as the basis for determining employer costs in fiscal year 2002. The unfunded liabilities of the plans are amortized over a 30 year period from June 30, 1999. The closed period ends 30 years from June 30, 1999.

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows.

3. Actuarial Assumptions and Methods

	ERS				
	State Employees	***Teachers***	**MERS**	**SPRBT**	**JRBT**
Valuation Date	6/30/04	6/30/04	6/30/04	6/30/04	6/30/04
Actuarial Cost Method	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal
Amortization Method	Level Percent of Payroll – Closed	Level Percent of Payroll – Closed	Level Percent of Payroll – Closed	Level Percent of Payroll – Closed	Level Percent of Payroll – Closed
Equivalent Single Remaining Amortization Period	25 years	25 years	25 Years	25 years	25 years
Asset Valuation Method	5 Year Smoothed Market	5 Year Smoothed Market	5 Year Smoothed Market	5 Year Smoothed Market	5 Year Smoothed Market
Actuarial Assumptions					
Investment Rate of Return	8.25%	8.25%	8.25%	8.25%	8.25%
Projected Salary Increases	4.50% to 8.25%	4.50% to 17.00%	*General Employees* 4.50% to 9.00% *Police & Fire Employees* 5.00% to 15.50%	5.00% to 15.00%	5.25%
Inflation	3.00%	3.00%	3.00%	3.00%	3.00%
Cost of Living Adjustments	Schedule A members -3.0% compounded Schedule B members – 2.5%	Schedule A members -3.0% compounded Schedule B members – 2.5%	3.0% Non-compounded	$1,500 per annum	3.0% (*see Note1(b)(4)*) to the financial statements

Schedule A - ERS members are those with 10 years or more of contributory service on or before July 1, 2005. Schedule B - ERS members are those with less than 10 years of contributory service on or before July 1, 2005. The plan provisions for Schedule A and B members are described in Note 1(b) to the financial statements entitled *Plan Descriptions – Membership and Benefit Provisions.*

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE OF THE AUDITOR GENERAL

ERNEST A. ALMONTE, CPA, CFE
Auditor General
ernest.almonte@oag.ri.gov

♦ *Integrity*
♦ *Reliability*
♦ *Independence*
♦ *Accountability*

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, 2005 and the related statements of changes in fiduciary net assets for the year then ended, and have issued our report thereon dated January 27, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and recommendations as findings 2005-1, 2005-2, 2005-3, and 2005-4.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider findings 2005-1, 2005-2, 2005-3, and 2005-4 to be material weaknesses.

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 an instance of noncompliance that is required to be reported under *Government Auditing Standards* and which is described as Finding 2005-9 in the accompanying Findings and Recommendations section.

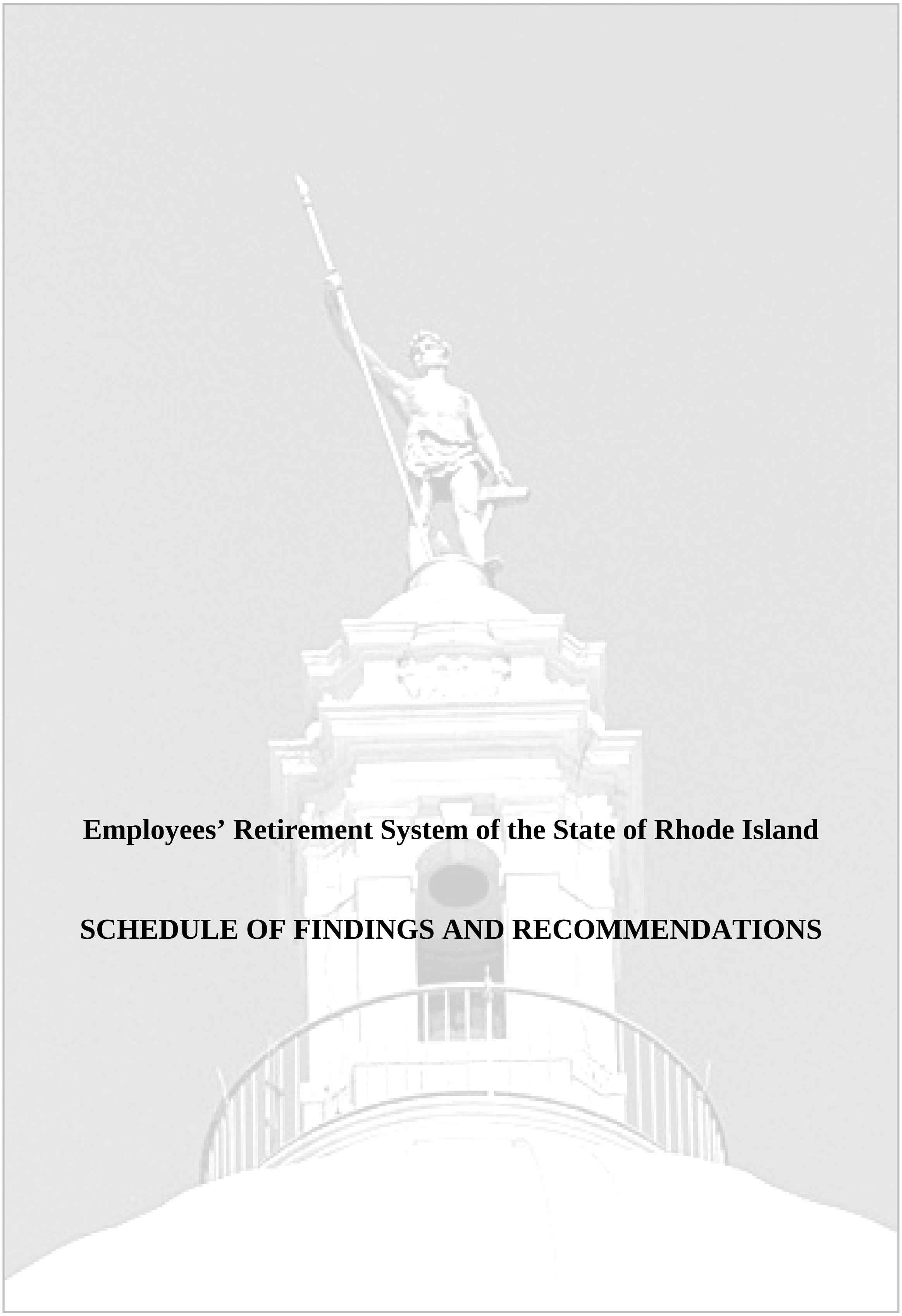
We also noted certain additional matters, as included in the accompanying Findings and Recommendations section which we reported to management of the System.

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

Ernest A. Almonte

Ernest A. Almonte, CPA, CFE
Auditor General

January 27, 2006



Employees' Retirement System of the State of Rhode Island

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

REPORTABLE CONDITIONS

FINDING 2005-1

PREPARE TIMELY BANK RECONCILIATIONS

Monthly bank reconciliations were not performed timely for the Employees' Retirement System of the State of Rhode Island (ERSRI) bank accounts during fiscal 2005. June 30, 2005 balances were not completely reconciled until November 2005. Timely bank reconciliations are an integral component of internal control over the recording of receipts and disbursements. Consequently, controls over receipts and disbursements were severely weakened during fiscal 2005. Delay in reconciling bank and book balances during fiscal 2005 was impacted by the fact that fiscal 2004 bank reconciliations were not completed until April 2005.

Near the close of fiscal 2005 and subsequently, ERSRI began to improve the availability and quality of information necessary to reconcile the System's bank accounts on a timely basis. These steps include addressing issues relating to how receipts are batched for deposit and entered into the accounting system to facilitate timely bank reconciliations, and also to reduce the extent of deposits made to an incorrect bank account.

RECOMMENDATIONS

2005-1a Reconcile all ERSRI bank accounts to the general ledger on a timely basis.

2005-1b Complete resolution of all issues that impact the availability and quality of information necessary to reconcile the System's bank accounts on a timely basis.

Auditee Views:

ERSRI concurs with these recommendations.

FINDING 2005-2

IMPROVE CONTROLS OVER FINANCIAL REPORTING

ERSRI's process for preparing financial statements is deficient. Information needed to prepare financial statements is not readily available and, in some cases, requires extensive analysis and correction. Personnel resources are insufficient to allow timely posting and monitoring of accounting data during the year. There is no timely and consistent management oversight of accounting data to ensure adherence to controls over financial reporting and to ensure data reported by the accounting system is accurate and consistent with normally expected results.

Refine the Accounting System to Meet ERSRI's Financial Reporting Needs

ERSRI implemented a new accounting system, known as ANCHOR, during fiscal 2002, which was designed to meet both its operational and financial reporting needs. In certain instances the system is not currently meeting the financial reporting needs of ERSRI. Balances reported by the system, most notably for contributions and contributions receivable, require significant analysis and adjustment to yield amounts that are appropriate for financial statements prepared in accordance with generally accepted accounting principles.

Certain of these issues involve how the system was programmed to meet various operational objectives. At times, these operational objectives, in their current form, are inconsistent with financial reporting objectives. For example, contributions received will remain as deferred revenue until the detail contribution data passes edit checks allowing the data to post to the contribution database. From a financial reporting perspective the contributions have been "earned" and should be reflected as revenue in the general ledger. Similarly, the State's matching contribution for teachers is not recorded until all contribution data has passed 100% of the system edits. For financial reporting purposes, revenue should be recognized as contributions to the system are due based upon employer payroll activity.

ERSRI should focus on the contributions revenue/ receivable cycle and assess how the Anchor and general ledger accounting systems handle the transactions and whether the data is consistent with financial reporting objectives. When the operational and financial reporting objectives are not consistent, ERSRI should explore options to make them consistent or develop specific data sources to meet financial reporting needs.

RECOMMENDATION

2005-2a Identify ANCHOR processes relating to the contributions revenue/ receivable cycle that are not consistent with financial reporting objectives. Explore options to make them consistent or develop specific data sources to meet financial reporting needs.

Auditee Views:

ERSRI concurs with this recommendation.

ERSRI currently performs the required reporting of revenue and receivables via a combination of system generated reports and manual adjustment. ERSRI will analyze this process with the goal of automating it.

Adopt a Standard Closing Process and Schedule

ERSRI has not adopted a formalized closing process which should detail required closing journal entries to be prepared at the end of the fiscal year. The standard closing process should be included in an accounting manual detailing the following information and processes:

- Data accumulation and analysis required to prepare the journal entries;
- Expected transaction flows, balances and relationships for specific accounts;
- Required journal entries including sample entries detailing specific accounts;
- Sources of data for each standard journal entry (e.g., external sources, Anchor reports, database queries, etc.);
- Frequency of posting the journal entries (e.g., annually, monthly);
- Accounting personnel responsible for preparing and approving the journal entries;
- Schedule for completion of the journal entries and closing process; and
- Required reconciliations to subsidiary detail or external data sources for certain account balances.

RECOMMENDATION

2005-2b Develop an accounting manual detailing a formalized closing process including sample journal entries, data sources for the journal entries, and responsibility for initiating and approving closing entries.

Auditee Views:

ERSRI concurs with this recommendation.

Ensure Resources are Adequate to Allow Accounting Functions to be Performed Timely and Implement Effective Oversight of the Accounting and Financial Reporting Functions

In recent fiscal years and through the time of our audit, ERSRI had insufficient personnel devoted to accounting functions. Consequently, numerous accounting functions were not performed timely and there was limited oversight of accounting and financial reporting functions. The Executive Director continues to be directly responsible for posting journal entries and preparing the draft financial statements. The lack of accounting resources contributed to the delay in preparing financial statements and severely weakened controls over financial reporting.

RECOMMENDATION

2005-2c Ensure adequate accounting resources exist to monitor control procedures and provide oversight of key accounting and financial reporting functions.

Auditee Views:

ERSRI concurs with this recommendation. In furthering this goal, reconfiguration of benefit, accounting, and hybrid functions, as well as realignment of management responsibilities to better reflect the division of benefit and accounting processes, were completed by fiscal year-end 2005.

FINDING 2005-3

IMPLEMENT RECONCILIATION CONTROLS OVER THE ANCHOR AND GENERAL LEDGER ACCOUNTING SYSTEMS

The ANCHOR system was designed to include a daily reconciliation function between data contained within the ANCHOR system and data contained within the PeopleSoft general ledger which is used for financial reporting purposes. The purpose of the reconciliation function is to ensure that the data contained within each system is fully synchronized. If variances do occur, the daily reconciliation process allows prompt investigation and correction. Although part of the system design, this function has never been fully operational.

We determined that there were no current operational procedures in place mandating that this reconciliation procedure detailed above, or any other type of reconciliation, be performed on a daily or 'as required' basis. This reconciliation process had not been performed, on any type of scheduled basis, since some point back in calendar year 2002.

Daily reconciliation between the Anchor and PeopleSoft components of the ERSRI accounting system is a critical control feature. Failure to perform this reconciliation is a weakness in control over financial reporting. Recently, ERSRI, working with its systems consultant, started to revisit this area of concern.

RECOMMENDATION

2005-3 Implement procedures to perform a daily automated reconciliation function between the ANCHOR and PeopleSoft components of the ERSRI accounting system.

Auditee Views:

ERSRI's original system design specifications acknowledged the criticality of daily reconciliation to control features in financial reporting. ERSRI has determined additional modifications are warranted. ERSRI is currently analyzing a refined daily reconciliation procedure within ANCHOR that has been successfully deployed by other clients of its consultant. Additionally, in FY 06, ERSRI is performing first level reconciliations between the ANCHOR system and its general ledger.

FINDING 2005-4

IMPROVE CONTROLS OVER DATA ENTRY TO ENSURE CORRECT POSTING OF DATA TO EMPLOYER ACCOUNTS

During the last four fiscal years data entry errors occurred which resulted in incorrect postings of contribution data to employer accounts. Because the system did not permit correction of this type of error, offline manual records of contributions by employer were maintained to supplement system generated data. Data contained within the system that is known to be inaccurate thereby necessitating offline records is problematic and compromises the reliability of all system reported data. These errors impact the accurate reporting of contributions and contributions receivable by employer unit.

Additional training and controls need to be implemented over the data entry process to ensure that data is correctly entered in to the system. When errors do occur, the system should allow, with appropriate controls, for correction of the erroneous data. ERSRI has recently implemented, and is now refining, a system modification that allows for correction of data entry errors.

RECOMMENDATIONS

2005-4a Implement additional training as needed to reduce data entry errors for employer contributions. Enhance controls over data entry to limit the opportunity for error.

2005-4b Complete implementation of the system modification that allows for correction of errors to employer contribution accounts.

Auditee Views:

ERSRI strengthened existing procedures and supplemented staff training during fiscal 2005 to reinforce internal controls on the cash receipt process.

ERSRI anticipates final implementation of the system modification in fiscal 2006.

OTHER FINDINGS AND RECOMMENDATIONS

FINDING 2005-5

ENHANCE MONITORING OF INVESTMENT COMPLIANCE AND ACCUMULATION OF INVESTMENT INFORMATION FOR FINANCIAL REPORTING PURPOSES

The State Investment Commission (SIC) is responsible for establishing guidelines and policies for investment of the ERSRI pension trust funds. The SIC does not directly manage the day-to-day investment of the portfolio but instead has adopted an asset allocation model with various external managers responsible for investing portfolio segments consistent with the SIC's directives. Each manager engaged by the SIC to invest a portion of the overall ERSRI portfolio is given a specific investment objective and guidelines including delineation of permitted and prohibited investments. The SIC, assisted by staff of the Office of the General Treasurer and external consultants, primarily assumes an oversight and monitoring function.

General Treasurer staff are responsible for monitoring investment manager performance and manager compliance with SIC directives and the activities of the System's investment custodian including accumulation of data for financial reporting purposes. General Treasurer staff can further enhance certain monitoring and oversight procedures relative to the System's investments in the following areas:

- ***Monitoring investment manager compliance with SIC directives***. During fiscal 2005 and prior General Treasurer staff recognized that portfolio monitoring tools provided by the System's investment custodian required enhancement and consequently, this aspect of investment monitoring could be improved. A new product offering from the System's custodian is now available which is expected to permit enhanced monitoring of investment manager compliance with SIC directives.

- ***Monitoring the activities of the System's investment custodian***. The System's investment custodian is responsible for trade settlement, custody of assets, reporting, and securities lending. General Treasurer staff could enhance oversight of the System's investment custodian by documenting follow-up on any issues highlighted in the custodian's periodic report on internal control procedures ("SAS 70" report). In addition, monitoring could be enhanced of the various reports provided by the custodian to ensure amounts are reported appropriately (e.g., cash contributions and withdrawals from the trusts, allocation of income between plans, classification of investments, etc.).

- ***Ensuring the System's investments are reported at fair value and required disclosure information is accumulated for financial reporting purposes in accordance with generally accepted accounting principles.*** A portion of the ERSRI investment portfolio is allocated to "alternative investment managers" which may include real estate, venture capital and other privately held investments. As required by generally accepted accounting principles, all ERSRI investments should be reported at fair value in the financial statements. By their nature, alternative investments are more challenging to present at fair value because valuation data is not as easily obtained. Accounting issues (some alternative investment managers follow tax-basis accounting rather than fair value), and timing issues (valuation is typically performed at calendar year end in conjunction with an annual audit rather than the ERSRI fiscal year end - June 30) further complicate the valuation. Once all relevant fair value data is accumulated, appropriate adjustments should be recorded within the System's accounting records to present all investments at management's best estimate of fair value in the financial statements.

  Various disclosures regarding the System's investments are required to be included within the financial statements regarding "derivative" investments. Improvements were made in accumulating derivative type investments information during fiscal 2005, however, the System can continue to enhance disclosures relative to derivative type investments in its financial statements.

  During fiscal 2005 the System implemented Governmental Accounting Standards Board Statement No. 40 - *Deposit and Investment Risk Disclosures*. Incorporating these required disclosures into the System's financial statements required the accumulation of significant amounts of new information.

  Additionally, review of the financial statements of the System's commingled fund investments provides relevant information regarding the specific holdings of the funds, its accounting practices, compliance with its specific investment objective, and other disclosures. Commingled fund type investments represent a significant portion of the System's total investments – 28% at June 30, 2005.

Staying current with generally accepted accounting principles and disclosure requirements as they relate to investments must be a shared responsibility between ERSRI management and General Treasurer staff responsible for the System's investments. However, we believe ERSRI should have primary responsibility and take the lead in staying current with generally accepted accounting principles and coordinating the accumulation of data for financial reporting purposes.

While some progress was made in coordinating the investment information needed for the System's fiscal 2005 financial statements, a permanent workgroup should be established with both ERSRI and General Treasurer personnel to (1) identify all required investment information (including derivative type investment disclosures) needed to prepare financial statements and (2) explore the options for accumulating the information from either internal or external sources (e.g., investment custodian, managers, consultants) and (3) ensure the required information is available on a timely basis for financial reporting purposes.

<u>RECOMMENDATIONS</u>

2005-5a Continue to enhance monitoring of investment manager compliance and the activities of the System's investment custodian.

2005-5b Establish a permanent workgroup comprised of ERSRI and General Treasurer personnel to identify all required investment information needed for financial reporting and explore options for accumulating the data. Assign responsibility for leading the effort to accumulate investment data needed for financial reporting to ERSRI.

<u>*Auditee Views:*</u>

During FY 06, the System's custodian replaced its first generation investment manager compliance product (formerly known as Investment Policy Reporting, "IPR") with an enhanced third-party comprehensive monitoring service, "Charles River Compliance."

Staff will continue to review and document its review of the bi-annual SAS 70 report. For the 2005 audit, Staff requested and received more comprehensive and detailed information from its private equity managers, consultants, and investment managers on derivatives holdings to meet disclosure requirements.

Commingled fund investments remain subject to more regulatory oversight than separately managed accounts and given their passive nature, are less volatile than actively managed separate accounts of the same mandate. The effectiveness of the review of the commingled fund annual financial statements is impacted by their delayed publication. Quarterly audited information from the plans general consultant and monthly and annual information provided by the investment managers will continue to be utilized for monitoring purposes.

The work group established during FY 06 will continue to meet to streamline the accumulation of data for financial reporting requirements.

FINDING 2005-6

PERFORM A RISK ANALYSIS / VULNERABILITY ASSESSMENT OF ERSRI's COMPUTER SYSTEMS

ERSRI has made a substantial investment in its computer system and now nearly all operations are accomplished through, and dependent upon, the system. Security over the ERSRI computer system is an important concern because of the nature of the information and the long time horizon on which the information is collected and used.

Information technology security risk analysis, also known as risk / vulnerability assessment, is fundamental to the overall security of any organization using automated systems in support of its daily operations. Security controls are the management, operational and technical safeguards or countermeasures found within an information system designed to protect the confidentiality, integrity, and availability of the system and its information. Security controls designed for a specific system should be commensurate with the risks associated with that system.

A formal review should be performed to determine what IT security controls are required to adequately protect the information systems that supports the day-to-day operations, and assets of the organization. This review would include these concerns:

- threats – all things that could go wrong or that can 'attack' the system. Threats would include all natural and man-made disasters, unauthorized use, fraud and abuse of the system and its data.
- vulnerabilities – these could allow a system to be more open to attack or make an attack more likely to succeed. There could exist both physical and logical vulnerabilities within any automated system.
- controls – these are specific countermeasures designed to mitigate vulnerabilities. Types of controls should include deterrent controls, preventative controls and corrective controls.

A risk/vulnerability assessment should be performed on a scheduled, recurring basis.

RECOMMENDATION

2005-6 Perform a risk analysis/vulnerability assessment of the ANCHOR system using appropriate methods and procedures to determine if controls have been implemented correctly, are operating as designed, producing the desired outputs, and meeting established security goals.

Auditee Views:

ERSRI concurs with this recommendation.

FINDING 2005-7

DEVELOP INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES

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

While ERSRI has implemented procedures that address selected areas of information security, a comprehensive organization-wide information systems security plan designed to meet all of the security needs of its automated systems has not been developed or implemented. Senior management should be directly involved in developing an appropriate information systems security plan. This plan should include the following components:

- ***security policies*** **–** these should be comprehensive, concise, understandable, enforceable, and offer a balance between protection and systems productivity.

- ***security procedures*** **–** should detail how ERSRI would accomplish specific security control objectives considering existing security 'best practices'.

The policy along with all of its component sections must be periodically updated. At a minimum the information systems security plan should be reviewed on a scheduled basis or as required by major modifications in operations, computer hardware or software.

RECOMMENDATION

2005-7 Develop and implement comprehensive information systems security policies and procedures that will assure adequate security is provided for all ERSRI information collected, processed, transmitted, disseminated, or stored within in any of its automated applications.

Auditee Views:

ERSRI concurs with this recommendation.

FINDING 2005-8

INVESTMENT INCOME ALLOCATION AMONG PLANS

ERSRI utilizes two primary trusts held by its custodian to hold cash and investments of the four plans - the "cash" trust holds a limited amount of liquid assets and the "pooled trust" holds most of the System's invested assets. While the assets held in each of the trusts are pooled, the custodian maintains accounting records delineating each plan's share of the trusts.

We found that the allocation of income in the cash trust between the ERS and MERS plans, as initially reported by the custodian, was materially misstated for the year ended June 30, 2005. This was subsequently corrected by the custodian, however, further analysis indicated that the way amounts had been moved between the pooled trust and cash trust to fund monthly pension benefits caused a misallocation of investment income between the plans. As cash was moved from the pooled trust to the cash trust (to meet pension benefits) it was apportioned to the plans by Treasury based on an estimate rather than the actual cash needs of each plan. Consequently, at June 30, 2005 the ERS plan had a negative cash balance in the cash trust of nearly $30 million while the MERS plan had a positive balance of $44 million. In essence the cash need of the ERS plan (to meet pension benefits) was greater than the amount actually withdrawn from the pooled trust. The reverse situation was true for MERS.

Investment income was misallocated among the plans because the allocation is made based on each plan's proportionate share of assets. The ERS plan's share of assets was overstated and the MERS plan's assets were understated, consequently income was over and under allocated respectively.

This situation existed in prior fiscal years, however, to a lesser extent. As a result, Treasury requested that the custodian adjust its records and reallocate investment income among the plans for fiscal years 2002 through 2005. The cumulative effect of the misallocation of investment income among the plans in prior years (excluding fiscal 2005) was $2.5 million overallocated to ERS, and $1.9 million, $340 thousand and $219 thousand underallocated to the MERS, State Police, and Judicial plans, respectively. Correcting adjustments have been included within investment income amounts reported for each plan in the System's fiscal 2005 financial statements.

Treasury must revise its methodology, in consultation with its investment custodian, to more closely approximate each plan's allocation of cash withdrawn from the pooled trust to meet pension benefits. Any adjustment to actual amounts should be made immediately in the next month to prevent any misallocation of investment income among the plans.

RECOMMENDATION

2005-8 Implement a revised methodology to withdraw cash required to meet pension benefit obligations from the pooled investment trust. Ensure the revised process results in actual rather than estimated amounts being recorded as withdrawals for each plan.

Auditee Views:

During FY 06, the methodology used to project plan specific monthly cash deficits was refined and necessary adjustments will be made on a monthly basis as necessary.

FINDING 2005-9

OVERPAYMENTS OF REFUNDS AND REFUNDS PAID TO BENEFICIARIES ENTITLED TO MONTHLY PENSION PAYMENTS

ERSRI overpaid the beneficiaries of some members of the System that died after retiring. State law allows System members to choose among various pension payment options. Two of these options, known as SRA Max and SRA Plus, entitle the retiree's beneficiary to a refund in the event that the retiree dies before he or she received pension payments exceeding their contributions to the System (death refunds in accordance with RIGL 36-10-23).

We found three instances where ERSRI overpaid refunds to beneficiaries of deceased retirees. In general, these overpayments were due to the fact that the amount of pension payments received by the retiree prior to the death was not deducted from the contribution balance.

We brought this matter to the attention of ERSRI's management, and it initiated a review of its systems and procedures to identify the scope and cause(s) of the overpayments. ERSRI advised us that it overpaid the beneficiaries of nine deceased retirees in an amount totaling $217,312.

Rhode Island General Law 36-10-18 stipulates that when System members choose pension payment options known as Option 1 or 2, the beneficiary shall receive, upon the member's death, a monthly annuity for life. In the event that a System member dies while in service, the member's spouse can also elect to receive a monthly annuity. In these instances, the beneficiaries are not entitled to a refund of the member's contributions.

We found that ERSRI paid two beneficiaries death refunds when they should have received a monthly annuity. In one case, the beneficiary was paid a refund amounting to $17,519 instead of a monthly annuity of $260. In the other instance, the beneficiary began receiving $470 per month upon the death of the member, and was also provided a full refund of the member's contributions totaling $20,505.

RECOMMENDATION

2005-9 Enhance controls to ensure that future death refund payments conform to state law, and beneficiaries receive the required monthly pension payments rather than refunds of member contributions; pursue recovery of all overpayments.

Auditee Views:

All systems, policies, and procedures are being enhanced to avoid recurrence and ERSRI is pursuing collection of overpayment.

FINDING 2005-10

COST OF LIVING ADJUSTMENT OVERPAYMENT

Rhode Island General Law 42-28-22 stipulates that members of the State Police participating in the State Police Retirement Benefits Trust (i.e., State Police and Superintendents hired after July 1, 1997) will receive upon retirement an annual cost of living adjustment (COLA) totaling $1,500 per annum beginning in the third January after retirement. The ANCHOR system was used to process one of these COLAs in fiscal 2005 and, due to a programming error, the retiree received the COLA before he was eligible. This caused an overpayment of $1,375.

RECOMMENDATION

2005-10 Recover the COLA overpayment, and reprogram the Anchor system to ensure that State Police cost of living adjustments are paid in accordance with state law.

Auditee Views:

Correction and reprogramming of the system has been completed and overpayment is being recovered.