

NOTES TO THE FINANCIAL STATEMENTS

NOTE 11: RETIREMENT PLANS

The State reports ten retirement plans as pension trust funds. Section A of this note describes the seven defined benefit public employee retirement plans and one defined contribution plan administered by the State. The remaining plans, described in Note 12, are defined contribution plans administered by a third party under the auspices of the State. The State may or may not make supplementary contributions to these plans. Although the assets of the administered plans are commingled for investment purposes, each plan’s assets may be used only for payment of benefits to the members of that plan and for administrative costs in accordance with the terms of the plan. The plans in this note do not issue separate financial statements, nor are they reported as part of other entities. The financial statements and other required disclosures are presented in Note 15 and in the *Required Supplementary Information* section of this *CAFR*. The State also provides an optional retirement plan for certain university employees and a special separation allowance for eligible sworn law enforcement officers.

A. Plan Descriptions and Contribution Information

1. TEACHERS' AND STATE EMPLOYEES' RETIREMENT SYSTEM

This plan is a cost-sharing, multiple-employer, defined benefit plan established by the State of North Carolina to provide pension benefits for employees of the State, its component units, and local boards of education not in the reporting entity. Membership is comprised of employees of state agencies and institutions, local boards of education, universities and community colleges and certain proprietary component units. At June 30, 2004, the number of participating local boards of education and component unit employers was 196 as shown below:

Local boards of education.....	117
Community colleges.....	58
University of North Carolina System	17
Proprietary component units.....	4

Benefits and administrative expenses are funded by member contributions of 6% of compensation, investment income, and by an actuarially required employer contribution established by legislation. For the period July 1, 2003 through June 30, 2004, the State made the actuarially based required contribution of .22% of covered payroll. Benefit and contribution provisions are established by G.S. 135-5 and 135-8 and may be amended only by the North Carolina General Assembly.

In addition to the actuarially based required contribution for this year, the State’s General Fund contributed an additional thirty million dollars to help offset the actuarial impact caused by the underpayment of contributions in fiscal 2001. Actual

payments made in relation to the required contributions for the State are shown in *Section D* of this note and in the *Required Supplementary Information* section of this report.

The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains of the plan.

2. CONSOLIDATED JUDICIAL RETIREMENT SYSTEM

This plan is a single-employer, defined benefit plan established by the State of North Carolina to provide pension benefits for employees of the State Judicial System. Membership is comprised of judges, district attorneys and clerks of court. The plan provides retirement, disability and death benefits. Benefits and administrative expenses are funded by member contributions of 6% of compensation, investment income, and by employer contributions. For the period July 1, 2003 through June 30, 2004, the State made the actuarially based required contribution of 11.05% of covered payroll. Benefit and contribution provisions are established by G.S. 135-57, 135-58, 135-68 and 135-69 and may be amended only by the North Carolina General Assembly.

In addition to the actuarially based required contribution for this year, the State contributed an additional .87% of payroll to help offset the actuarial impact caused by the underpayment of contributions in fiscal 2001. Actual payments made in relation to the required contributions for the State are shown in *Section D* of this note and in the *Required Supplementary Information* section of this report.

The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains of the plan.

3. LEGISLATIVE RETIREMENT SYSTEM

This plan is a single-employer, defined benefit plan established by the State of North Carolina to provide retirement and disability benefits for members of the General Assembly.

The benefit will not be payable while the member is employed in a position making him eligible to participate in either the Teachers' and State Employees' Retirement System, Consolidated Judicial Retirement System or the Local Governmental Employees' Retirement System. Benefits and administrative expenses are funded by member contributions of 7% of compensation, investment income, and by actuarially based employer contributions. For the period July 1, 2003 through June 30, 2004, there was no actuarially based required contribution and none was made. Benefit and actuarially based contribution provisions are established by G.S. 120-4.21, 120-4.19 and 120-4.20 and may be amended only by the North Carolina General Assembly.

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The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains of the plan.

OTHER STATE ADMINISTERED SYSTEMS

The State also administers the following pension and retirement plans for persons who are not considered employees of the State or its component units.

4. *FIREMEN'S AND RESCUE SQUAD WORKERS' PENSION FUND*

This plan is a defined benefit pension plan established by the State of North Carolina to provide pension benefits for all eligible firemen and rescue squad workers. Membership is composed of both volunteer and locally employed firemen and emergency medical personnel who elect membership. At June 30, 2004, there were 1,488 participating fire and rescue units. This is a special funding situation in that the State is not the employer but is legally obligated to contribute to the plan.

For this fiscal year, in addition to its actuarially required contribution the State made additional contributions of \$54,923 to be applied against underpayments in 2001. Actual contributions made in relation to the required contributions for the State are shown in *Section D* of this note and in the *Required Supplementary Information* section of this report.

Benefits and administrative expenses are funded by a \$10 monthly contribution by the member, investment income and an actuarially based state appropriation. Benefit and contribution provisions are established by G.S. 58-86 and may be amended only by the North Carolina General Assembly.

5. *NATIONAL GUARD PENSION FUND*

This plan is a defined benefit plan established by the State of North Carolina to provide pension benefits for members of the North Carolina national guard. This is also a special funding situation, because the State is not the employer but is legally obligated to contribute to the plan.

For this fiscal year, in addition to its actuarially required contribution the State made additional contributions of \$1,845,490 to be applied against underpayments in prior years. Actual contributions made in relation to the required contributions for the State are shown in *Section D* of this note and in the *Required Supplementary Information* section of this report.

Benefits and administrative expenses are funded by an actuarially based state appropriation and investment income. Benefit and contribution provisions are established by G.S. 127A-40 and may be amended only by the North Carolina General Assembly.

6. *REGISTERS OF DEEDS' SUPPLEMENTAL PENSION FUND*

This plan is cost-sharing, multiple-employer, defined benefit plan established by the State of North Carolina to provide supplemental pension benefits for all eligible, retired county registers of deeds. Membership is composed of registers who are retired from the Local Governmental Employees' Retirement System or an equivalent local plan and have met the statutory eligibility requirements. At June 30, 2004, there were 100 registers enrolled in the plan with all 100 counties participating. An individual's benefits for the year are calculated as a share of accumulated contributions available for benefits for that year, subject to certain statutory limits. An individual's eligibility is based on minimum years of service as a register with the individual's share increasing with years of service. Because of the statutory limits noted above, not all contributions available for benefits are distributed. The State Treasurer administers the plan and *Section B* of this note describes the accounting and investing for the plan. The State's only cost in the plan is administration.

Benefits and administrative expenses are funded by 4.5% of the receipts collected by each County Commission under Article 1 of Chapter 161 of the General Statutes and investment income. Registers do not contribute. The actuarially required contribution and percentage of that contribution actually made is in the *Required Supplementary Information* section of this report. All benefit and contribution provisions are established by General Statute 161-50 and may be amended only by the North Carolina General Assembly.

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7. SHERIFFS' SUPPLEMENTAL PENSION FUND

This plan is defined contribution plan established by the State of North Carolina to provide supplemental pension benefits for all eligible, retired county sheriffs. Membership is composed of sheriffs who are retired from the Local Governmental Employees' Retirement System and have met the statutory eligibility requirements. At June 30, 2004, there were 82 sheriffs enrolled in the plan with all 100 of the State's counties eligible to participate.

An individual's benefits for the year are calculated as a share of accumulated contributions available for benefits for that year, subject to certain statutory limits. An individual's eligibility is based on minimum years of service as a sheriff with the individual's share increasing with years of service. Because of the statutory limits noted above, not all contributions available for benefits are distributed. The North Carolina Department of Justice administers the plan. If the plan purchases any investments, they are held as part of the State Treasurer's Investment Pool. *Section B* of this note describes the accounting and investing for the plan. The State's only cost in the plan is administration.

Receipts collected by each county's Clerk of Superior Court under General Statute 7A-304(a)(3a), along with investment income, support the plan's benefits and administrative expenses. Sheriffs do not contribute to the plan. For the year ended June 30, 2004, the Clerks remitted \$758,910. All benefit and contribution provisions are established by General Statute 143-166 and may be amended only by the North Carolina General Assembly.

8. LOCAL GOVERNMENTAL EMPLOYEES' RETIREMENT SYSTEM

This plan is a cost-sharing, multiple-employer, defined benefit plan established by the State of North Carolina for employees of local governments. Membership is comprised of general employees and local law enforcement officers of participating local governmental entities. At June 30, 2004, the number of participating local governments was 907, as shown below:

Cities	421
Counties	100
Special districts	386

The plan provides retirement benefits nearly identical to the benefits that accrue to members of the Teachers' and State Employees' Retirement System. This plan also provides disability benefits for members who become totally and permanently disabled from performing their usual job. Benefits and administrative expenses are funded by employee contributions of 6% and actuarially based employer contributions. All employers contribute 4.12% of covered payroll for law enforcement officers and 3.65% for general employees and firemen. In addition, employers with an unfunded liability, which is established when the government initially enters the system, must make additional contributions towards that liability. The State's only cost is administrative. Benefit and contribution provisions are established by G.S. 128-27 and 128-30 and may be amended only by the North Carolina General Assembly.

The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains.

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The following table summarizes membership information by plan at the actuarial valuation date:

Employee Groups	Teachers' and State Employees'	Judicial	Legislative	Firemen's, Rescue	National Guard	Registers of Deeds'	Local Governmental
Retirees and beneficiaries currently receiving benefits	123,077	408	235	8,903	2,319	69	34,861
Terminated employees entitled to benefits but not yet receiving them	52,755	56	90	152	6,813	1	16,664
Active plan members	303,768	497	170	32,166	7,281	101	119,755
Total	<u>479,600</u>	<u>961</u>	<u>495</u>	<u>41,221</u>	<u>16,413</u>	<u>171</u>	<u>171,280</u>
Date of Valuation	12-31-03	12-31-03	12-31-03	6-30-03	12-31-03	12-31-03	12-31-03

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND PLAN ASSET MATTERS

BASIS OF ACCOUNTING

The financial statements of these plans are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions 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.

INVESTMENTS / SECURITIES LENDING

Pursuant to North Carolina General Statutes, the State Treasurer is the custodian and administrator of the retirement systems. The State Treasurer maintains various investment portfolios in its Investment Pool. The investment balance of each system represents its share of the fair value of the net assets of the various portfolios within the pool. Additionally, the securities lending balance represents assets occurring from securities lending transactions that result from the systems'

participation in the pool. The investments of the State Treasurer and securities lending are fully discussed in Note 3.

No retirement system has investments in any single commercial or industrial organization whose fair value would amount to more than five percent of the system's net assets available for benefits.

C. Actuarial Methods and Assumptions

The latest actuarial valuations are dated December 31, 2003 (June 30, 2003, for Firemen's and Rescue Squad Workers' Fund). The actuarial accrued liability and the schedule of funding progress are presented by system in the *Required Supplementary Information*. The actuarial value of assets for all systems is based on a five-year smoothed market value. Under this method, realized and unrealized gains and losses on investments are smoothed over five years. Below are listed the various actuarial methods and significant assumptions for these valuations that will be used to determine future annual required contributions.

<i>Retirement System</i>	<i>Valuation Date</i>	<i>Actuarial Cost Method</i>	<i>Amortization Method</i>	<i>Remaining Amortization Period</i>	<i>Period Open/Closed</i>	<i>Asset Valuation Method</i>	<i>Actuarial Assumptions</i>	
							<i>Investment Rate of Return</i>	<i>Projected Salary Increase</i>
Teachers' and State Employees'	12/31/03	Entry age	Level dollar	9 years	Open	5 year smoothed	7.25%	5.45-12.08%
Consolidated Judicial	12/31/03	Projected unit credit	Level percentage	9 years	Open	5 year smoothed	7.25%	5.63-12.58%
Legislative	12/31/03	Projected unit credit	Level dollar	8 years	Open	5 year smoothed	7.25%	7.50%
Firemen's, Rescue Squad Workers'	6/30/03	Entry age	Level dollar	9 years	Open	5 year smoothed	7.25%	N/A
National Guard	12/31/03	Entry age	Level dollar	9 years	Open	5 year smoothed	7.25%	N/A
Registers of Deeds'	12/31/03	Entry age	Level dollar	N/A	Open	5 year smoothed	7.25%	5.45-12.08%
Local Governmental Employees'	12/31/03	Frozen entry age	Level percentage	Various	Closed	5 year smoothed	7.25%	5.45-12.08%

N/A-Not applicable

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The valuations for the Teachers' and State Employees' system, Legislative system, and Consolidated Judicial system reflect a 1.70% cost of living increase for retirees in these systems. The Firemen's and Rescue Squad Workers' Fund increased retirement benefits by \$3 (from \$158 to \$161). The Local Governmental Employee's system did not receive a cost of living increase. All of the benefit enhancements listed in this paragraph reflect legislation enacted by the North Carolina General Assembly effective July 1, 2004.

As of this valuation, the unfunded actuarial accrued liability for the Registers of Deeds' system, when amortized over 40 years is less than zero (\$0) and produces a negative annual required contribution (ARC). In this situation, common actuarial practice sets the ARC at zero and makes the remaining amortization period not applicable.

The projected investment returns and projected salaries for all systems, except the Legislative, include a 3.75% inflationary factor within the actuarial assumption. The assumption for the Legislative system does not identify an inflationary factor.

CURRENT FISCAL YEAR ASSUMPTIONS

Unless otherwise noted in this footnote or in the required supplementary schedules, the actuarial values, methods and significant assumptions for the current year's required contributions are the same as those presented in the table shown on the prior page. The annual required contributions (ARC) for the fiscal year ended June 30, 2004, were developed from various prior year valuations. The Teachers' and State Employees', Local Governmental

Employees', Consolidated Judicial, Registers of Deeds' and National Guard systems' valuations were as of December 31, 2001, the Legislative system was valued at December 31, 2002, and the Firemen's and Rescue Squad Worker's Fund was valued at June 30, 2002. These valuations used amortization periods of 20 years for the Registers of Deeds', 9 years for Consolidated Judicial, 9 years for National Guard and 9 years for the Firemen's and Rescue Squad Worker's Fund. The Teachers' and State Employees' system, which had used an 11 year amortization in the prior year's valuation, returned to a 9 year amortization period. The Local Governmental Employees' system is an aggregate of numerous employers, and consequently, has various amortization periods. The rate of investment return and projected salary increases used in these valuations assumed essentially the same increases as in the most current valuations reported on the prior page.

For the fiscal year ended June 30, 2004, the Local Governmental Employees' system provided various levels of cost of living adjustments effectively increasing benefits from 3.5% to 9.5%. This system also increased the benefit accrual rate from 1.82% to 1.85%. The Teachers' and State Employees' system, Legislative Retirement system and the Consolidated Judicial system provided a 1.28% cost of living increase for retirees in these systems. The Firemen's and Rescue Squad Workers' Fund increased retirement benefits by \$2 (from \$156 to \$158). All of these benefit enhancements reflect legislation enacted by the North Carolina General Assembly that was effective July 1, 2003. These enhancements were either reflected as liabilities in the December 31, 2002 valuations, or the systems paid for them through actuarial gains.

D. Annual Pension Cost and Net Pension Obligation

The annual pension costs and net pension obligations for the State's single-employer and special funding defined benefit plans for the current fiscal year are as follow (in thousands):

	Consolidated Judicial Retirement System	Legislative Retirement System	Firemen's and Rescue Squad Workers' Pension Fund	North Carolina National Guard Pension Fund
Annual required contribution.....	\$ 5,583	\$ —	\$ 6,801	\$ 1,176
Interest on net pension obligation.....	150	(2)	63	125
Adjustment to annual required contribution.....	(329)	8	(134)	(258)
Annual pension cost.....	5,404	6	6,730	1,043
Less: Contributions made.....	6,023	—	6,856	3,021
Increase (decrease) in net pension obligation.....	(619)	6	(126)	(1,978)
Net pension (asset) obligation beginning of year....	2,068	(31)	863	1,725
Net pension (asset) obligation end of year.....	<u>\$ 1,449</u>	<u>\$ (25)</u>	<u>\$ 737</u>	<u>\$ (253)</u>

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The following table presents the required three year trend of pension costs for the State's single-employer and special funding defined benefit plans and the annual required contributions (ARC) the State made to the Teachers' and State Employees' Retirement System (the System), a cost-sharing, multiple-employer plan. The State's statutory annual contribution equals its total annual payment to the System and equals the State's pension cost in these financial statements. The State does not make any contributions to the Local Governmental Employees' System; therefore, it does not have any related pension cost.

**State of North Carolina's Annual Pension Cost (APC)
and Annual Required Contributions (ARC) as an Employer**
For the Years Ended June 30, 2002 through June 30, 2004 (in thousands)

	<u>Teachers' and State Employees'</u>	<u>Judicial</u>	<u>Legislative</u>	<u>Firemen's, Rescue</u>	<u>National Guard</u>
Primary Government:					
2004 (A)	\$ 35,762	\$ 5,404	\$ 6	\$ 6,730	\$ 1,043
2003	—	5,870	6	6,778	1,083
2002	50,835	6,852	844	9,942	1,542
Component units:					
Universities:					
2004	\$ 3,038				
2003	—				
2002	24,829				
Community Colleges:					
2004	\$ 1,211				
2003	—				
2002	9,676				
Proprietary Funds:					
2004	\$ 38				
2003	—				
2002	333				
Total Primary Government and Component Units:					
2004	\$ 40,049	\$ 5,404	\$ 6	\$ 6,730	\$ 1,043
2003	-	5,870	6	6,778	1,083
2002	85,673	6,852	844	9,942	1,542
Percentage of APC Contributed:					
2004		112%	0%	102%	290%
2003		102%	0%	101%	0%
2002		124%	114%	101%	58%
Percentage of ARC Contributed:					
2004	100%				
2003	No ARC				
2002	100%				
Net Pension (Asset) Obligation:					
2004		\$ 1,449	\$ (25)	\$ 737	\$ (253)
2003		2,068	(31)	863	1,725
2002		2,191	(37)	941	643

(A) - The State's contribution/pension cost for the Teachers' and State Employees' Retirement System equals the actuarially required contribution plus 30 million dollars in additional appropriations mandated by the N.C. General Assembly.

Yearly pension liabilities for the systems are shown in the *Required Supplementary Information* section of this report. Beginning with the accounting transition year of 1997, liabilities were determined in accordance with Governmental Accounting Standards Board Statement No. 27 (GASB 27). As presented here, each system's yearly APC and net pension (asset) obligation were computed retroactively to 1993 in accordance with GASB 27 and contain the cumulative effect of applying that statement.

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The Optional Retirement Program (Program) is a defined contribution retirement plan that provides retirement benefits with options for payments to beneficiaries in the event of the participant's death. Faculty and administrators with faculty rank in universities of the UNC System may join the Program instead of the Teachers' and State Employees' Retirement System. At June 30, 2004, the Plan had 9,985 participants.

Benefits are provided by means of contracts issued and administered by the privately-operated Teachers' Insurance and Annuity Association and the College Retirement Equities Fund (TIAA/CREF), Valid, Fidelity Investments and Lincoln National Life Insurance Company. Participants' eligibility and contributory requirements are established in G.S. 135-5.1. Participants contribute 6% of compensation and the university contributes 6.84%. There is no liability other than the universities' required contributions. The universities contributed \$57,667,191 for the 2003-04 fiscal year. Annual covered payroll was \$843,087,589 and employer contributions expressed as a percentage of annual covered payroll were 6.84% for the fiscal year ended June 30, 2004. Employee contributions expressed as a percentage of annual covered payroll were 6%, with actual employee contributions of \$50,585,256 for the 2003-04 fiscal year.

Participants are vested after five years of service, but the company must return the value of the universities' contributions to the State if termination occurs prior to five years of service. The participant chooses his/her own investment products with the company of choice.

F. Special Separation Allowance

The State provides a special separation allowance (SSA), an agent multiple-employer, defined benefit pension plan, for sworn law enforcement officers as defined by G.S. 135-1(11b) or G.S. 143-166.30(a)(4) that were employed by State agencies and component units and retired on a basic service retirement under the provisions of G.S. 135-5(a). To qualify for the allowance, each retired officer must: (1) have completed 30 or more years of creditable service or have attained 55 years of age and completed five or more years of creditable service; and (2) not have attained 62 years of age; and (3) have completed at least five years of continuous service as a law enforcement officer immediately preceding a service retirement. Each eligible officer is paid an annual separation allowance equal to .85% of the officer's most recent base rate of compensation for each year of creditable service. For the fiscal year ended June 30, 2004, the State and its component units paid \$11,439,512 for 873 retired law enforcement officers. These benefits are funded on a pay-as-you-go basis with each employer (the State or component unit) responsible for the benefits to their former employees. There is no statewide administration of the SSA and there is no actuarial valuation performed. Funds for this allowance are appropriated annually in the budget of each affected state agency or paid from the component unit's operations. These benefits are established in G.S. 143-166.41 and may be amended only by the General Assembly.