

# FINANCIAL SECTION

## INDEPENDENT AUDITOR'S REPORT



**ANDREWS HOOPER & PAVLIK P.L.C.**  
Certified Public Accountants

### Independent Auditor's Report

Municipal Employees' Retirement System of Michigan Retirement Board:

We have audited the accompanying statements of plan net assets of the Municipal Employees' Retirement System of Michigan as of December 31, 2005, and the related statements of changes in plan net assets for the year then ended. These financial statements are the responsibility of the management of the Municipal Employees' Retirement System of Michigan. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year comparative information has been derived from the 2004 financial statements and, in our report dated May 20, 2005, we expressed an unqualified opinion on those financial statements.

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. 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Municipal Employees' Retirement System of Michigan as of December 31, 2005, and the changes in its financial status for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 24, 2006 on our consideration of the Municipal Employees' Retirement System of Michigan's internal control over financial reporting and on 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 (MD&A) is not a required part of the basic financial statements but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this supplemental information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Introductory, Investment, Actuarial, and Statistical Sections and the required supplementary information and supporting schedules listed in the table of contents are presented for the purpose of additional analysis and are not a required part of the basic financial statements. The Introductory, Investment, Actuarial, and Statistical Sections and the required supplementary information and supporting schedules are the responsibility of the Municipal Employees' Retirement System of Michigan's management. The Schedules of Funding Progress and Employer Contributions and related notes and the supporting schedules have been subjected to the auditing procedures applied in our audit of the basic financial statements, and in our opinion, are fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole. The Introductory, Investment, Actuarial, and Statistical Sections were not audited by us and, accordingly, we express no opinion on those sections.

*Andrews Hooper & Pavlik P.L.C.*

Okemos, Michigan  
April 24, 2006

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### MANAGEMENT'S DISCUSSION AND ANALYSIS

This narrative overview and analysis of MERS' financial condition for fiscal year ended December 31, 2005, is presented in conjunction with the Chief Executive Officer's Letter of Transmittal. The Financial Section is comprised of the independent auditor's report, this management's discussion and analysis, two basic financial statements with explanatory notes, two required supplementary schedules with explanatory notes, three supplementary expense schedules, summation of 2005 financial highlights, analysis of plan net assets, investment activity, historical trends, and funding status.

MERS was created to provide retirement, survivorship and disability benefits to qualified members and their beneficiaries. The cost of administering such benefits includes: (1) payment of monthly benefits as designated by the Defined Benefit Plan, Defined Contribution Plan, Health Care Savings Program and Retiree Health Funding Vehicle, (2) refund of member contributions requested by employees that separate from employment, and (3) payment of all administrative and investment costs associated with administering the plans.

#### ***Financial Statements***

1. Statement of Plan Net Assets (pages 26-27)
2. Statement of Changes in Plan Net Assets (pages 28-29)
3. Notes to Basic Financial Statements (pages 30-45)
4. Comparison Statement of Plan Net Assets (page 22)
5. Comparison Statement of Changes in Plan Net Assets (page 23)

The Defined Benefit Plan, Defined Contribution Plan, Health Care Savings Program and Retiree Health Funding Vehicle are premised upon long-term investing. Therefore, current financial statements alone do not provide the total perspective to properly assess the retirement system's long-term financial condition.

The "Statement of Plan Net Assets" and "Statement of Changes in Plan Net Assets" provide the current financial condition of the 645 individual municipal Defined Benefit Plans, 107 individual municipal Defined Contribution Plans, 31 Health Care Savings Programs and 16 Retiree Health Funding Vehicle Plans administered by MERS. The "Comparison Statement of Plan Net Assets" and "Comparison Statement of Changes in Plan Net Assets" provide a comparative summary of the financial condition of the retirement system as a whole.

#### ***Required Supplemental Information***

1. Schedule of Funding Progress (page 46)
2. Schedule of Employer Contributions (page 46)
3. Notes to the Schedules of Required Supplementary Information (pages 47-48)

The "Schedule of Funding Progress" shows the progress MERS has made in accumulating sufficient assets to pay future retirement benefits when due. The schedule sets forth the actuarially funded status of the

Defined Benefit Plan with historical trends in funding. The “Schedule of Employer Contributions” shows the current annual employer contributions and the historical trend of employer contributions. From a long-term investment perspective, these schedules provide a better understanding of the changes over time in the funded status of the plan.

### ***Expense Schedules***

1. Schedule of Administrative Expenses (page 49)
2. Schedule of Investment Expenses (page 50)
3. Schedule of Payments to Consultants (page 51)

The expense schedules summarize all expenses associated with administering the Defined Benefit Plan.

### ***Financial Highlights***

The following financial highlights occurred during fiscal year ended December 31, 2005:

- Total plan net assets for the Defined Benefit Plan, Defined Contribution Plan, Health Care Savings Program and Retiree Health Funding Vehicle increased by \$323 million during the 2005 fiscal year. This was primarily due to net gains in investments of \$301 million dollars.
- Total pension benefits paid to retirees and beneficiaries increased \$30 million to a total of \$284 million. While contributions exceeded pension benefit payments by \$28 million in 2005 (primarily due to new municipalities joining MERS), the cash flow trend in the past few years has shown pension benefit payments are increasingly exceeding contributions. This is normal plan cycling as the defined benefit plan matures and is due in large part to baby boomers reaching retirement age and drawing pension benefits.
- Refunds of Defined Benefit Plan employee contributions paid to former members upon termination of employment increased over the previous year by \$.6 million.
- Transfers from the Defined Benefit Plan to the Defined Contribution Plan decreased by \$300 thousand. While there has been a steady decline in the number of Defined Benefit members transferring to Defined Contribution over the past few years, the number of new hires in Defined Contribution has increased relative to the Defined Benefit Plan members.
- Total employer contributions increased by 29% to \$236 million, and employee contributions increased by 27% to \$76 million. Again, much of these increases were due to new municipalities joining MERS Defined Benefit Plan, Defined Contribution Plan, Retiree Health Funding Vehicle, and Health Care Savings Program. Employer and employee contributions from new municipalities were \$49 million in 2005 compared to \$14 million in 2004. Employer contributions in the Defined Benefit Plan have increased in recent years due to municipalities adopting enhanced benefits and the market declines of 2000-2002.

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- Administrative expenses totaled \$12 million. Much of this increase was due to the added costs of hiring additional staff and depreciation of software, computer servers and office equipment used in administering the Defined Benefit Plan with 63,394 members and Defined Contribution Plan with 7,393 members.
- Investment expenses totaled \$17 million. The largest expense is due to higher investment manager fees increasing to \$15 million. This is not unexpected with the market increases of the past year.

### *Using this Financial Report*

Because of the long-term nature of a defined benefit plan, financial statements alone cannot provide sufficient information to properly reflect the retirement system's ongoing plan perspective. This financial report consists of two financial statements and two required schedules of historical trend information. The "Statement of Plan Net Assets" and "Statement of Changes in Plan Net Assets" (pages 26-29) provide financial information about the activities of the 799 individual municipal plans administered by MERS in its Defined Benefit Plan, Defined Contribution Plan, Retiree Health Funding Vehicle, and Health Care Savings Program, as well as comparative summary information about these activities for the retirement system as a whole.

The "Schedule of Funding Progress" (page 46) includes historical trend information about the actuarially funded status of the plan from a long-term, ongoing plan perspective and the progress made in accumulating sufficient assets to pay benefits when due. The "Schedule of Employer Contributions" (page 46) presents historical trend information about the annual actuarially required contributions of employers and the actual contributions made by employers in relation to this requirement. These schedules provide information that contributes to understanding the changes over time in the funded status of the plans.

## COMPARISON STATEMENT OF PLAN NET ASSETS

| Assets   | As of                   |                         | Increase (Decrease)   |              |
|--|-------------------------|-------------------------|-----------------------|--------------|
|  | December 31, 2005       | December 31, 2004       | Amount                | Percent      |
| Cash and Short-Term Investments                      | \$ 266,259,383          | \$ 197,094,797          | \$ 69,164,586         | 35.09%       |
| Receivables  | 157,534,335             | 119,378,154             | 38,156,181            | 31.96%       |
| Interfund Receivables                                | 434,593                 | 436,427                 | (1,834)               | -0.42%       |
| Investments, at fair value                           | 4,985,756,769           | 4,610,306,560           | 375,450,209           | 8.14%        |
| Invested Securities Lending Collateral               | 719,094,377             | 659,513,777             | 59,580,600            | 9.03%        |
| Other Assets/Prepays                                 | 433,475                 | 465,270                 | (31,795)              | -6.83%       |
| Net Capital Assets                                   | 3,878,603               | 2,772,594               | 1,106,009             | 39.89%       |
| Total Assets   | 6,133,391,535           | 5,589,967,579           | 543,423,956           | 9.72%        |
| <b>Liabilities</b>                                   |                         |                         |                       |              |
| Purchase of Investments                              | 317,984,276             | 159,923,488             | 158,060,788           | 98.84%       |
| Securities Lending Collateral                        | 719,094,377             | 659,513,777             | 59,580,600            | 9.03%        |
| Administrative and Investment Costs                  | 6,563,876               | 3,772,173               | 2,791,703             | 74.01%       |
| Interfund Payables                                   | 434,593                 | 436,427                 | (1,834)               | -0.42%       |
| Unspecified Contributions                            | 711                     | 711                     | -                     | 0.00%        |
| Total Liabilities                                    | 1,044,077,833           | 823,646,576             | 220,431,257           | 26.76%       |
| <b>Net assets held in trust for pension benefits</b> | <b>\$ 5,089,313,702</b> | <b>\$ 4,766,321,003</b> | <b>\$ 322,992,699</b> | <b>6.78%</b> |

## COMPARISON STATEMENT OF CHANGES IN PLAN NET ASSETS

|  | Year ended<br>December 31, 2005 | Year ended<br>December 31, 2004 | Increase (Decrease)<br>Amount | Increase (Decrease)<br>Percent |
|--|---------------------------------|---------------------------------|-------------------------------|--------------------------------|
| <b>Additions</b>                                     |                                 |                                 |                               |                                |
| Contributions  | \$ 312,245,705                  | \$ 243,019,370                  | \$ 69,226,335                 | 28.49%                         |
| Transfers from Defined Benefit Plan                  | 22,573                          | 321,966                         | (299,393)                     | -92.99%                        |
| Transfers from Other Plans and Other Items           | 2,084,281                       | 5,356,930                       | (3,272,649)                   | -61.09%                        |
| Investment net income investing activities           | 300,666,864                     | 596,008,057                     | (295,341,193)                 | -49.55%                        |
| Investment net income-securities lending             | 2,135,791                       | 1,341,339                       | 794,452                       | 59.23%                         |
| Miscellaneous Income                                 | 6,026,437                       | 819,466                         | 5,206,971                     | 635.41%                        |
| Total Additions                                      | 623,181,651                     | 846,867,128                     | (223,685,477)                 | -26.41%                        |
| <b>Deductions</b>                                    |                                 |                                 |                               |                                |
| Benefits   | 283,776,492                     | 253,918,782                     | 29,857,710                    | 11.76%                         |
| Refunds of Contributions                             | 4,157,567                       | 5,252,652                       | (1,095,085)                   | -20.85%                        |
| Special Expenses and Fees                            | 398,690                         | 387,031                         | 11,659                        | 3.01%                          |
| Transfers to Defined Contribution Program            | 22,573                          | 321,966                         | (299,393)                     | -92.99%                        |
| Administrative Expense                               | 11,833,630                      | 10,144,051                      | 1,689,579                     | 16.66%                         |
| Total Deductions                                     | 300,188,952                     | 270,024,482                     | 30,164,470                    | 11.17%                         |
| <b>Net Increase</b>                                  | 322,992,699                     | 576,842,646                     | (253,849,947)                 | -44.01%                        |
| <b>Net assets held in trust for pension benefits</b> |                                 |                                 |                               |                                |
| Balance Beginning of Year                            | 4,766,321,003                   | 4,189,478,357                   | 576,842,646                   | 13.77%                         |
| Balance End of Year                                  | \$ 5,089,313,702                | \$ 4,766,321,003                | \$ 322,992,699                | 6.78%                          |

*Analysis of Plan Net Assets*

Combined plan net assets increased by \$323 million over the previous fiscal year. Looking at additions to and deductions from plan net assets, the increase in net assets was primarily attributable to economic conditions (the stock market's rise) and municipalities increasing benefit multipliers and adopting benefit enhancements resulting in higher employer/employee contributions. Deductions from plan net assets were attributable to a 12% increase in pension benefit payouts to a greater number of retirees and post-retirement cost-of-living increases.

Employer and employee contributions increased \$69 million chiefly due to municipalities joining MERS plans bringing in \$49 million. The remaining increases were due to higher required actuarial contribution rates resulting from increases in salaries, benefit enhancements, plan modifications, and an increase in the number of employees.

In determining contribution rates through 2005, MERS' actuary used a five-year smoothing method to recognize market gains and losses, and this has tempered many of the market losses over the three down market years. For 2003, the Retirement Board adopted a one time ad hoc adjustment to aggregate the yet unrecognized market gains and losses from 1999-2002 with the 2003 market gain. For 2003, no gain or loss was recognized. The aggregate loss amount of \$388,778,035 was to be recognized in four equal dollar installments in 2004-2007. In 2004, the normal five-year smoothing method was reinstated. In 2006, to further reduce the volatility of employer contribution rates, the MERS Board adopted a ten-year smoothing method for calculating valuation assets. Employers are also shifting more of the responsibility for contribution requirements onto employees to pay for better benefit plans.

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MERS has capital assets of approximately \$4 million, most of which are software and computer servers needed to run the retirement system's programs.

MERS has no long-term liabilities. The bulk of MERS' liabilities at year end related to investment purchases that did not settle until 2006.

### *Investment Activities*

The total fund investment performance on a relative basis to benchmarks was excellent. The positive gross return of 6.8% was below the long-term net 8% actuarial return assumption target for the year. On both a five and ten year basis, the gross returns of 6.6% and 8.7%, respectively, compared favorably to the actuarial return assumption. Net investment income (net increase in fair value, plus investment earnings, less investment administrative expenses) was \$303 million for the year. The stock market is in its third year of positive returns after three years of negative returns. A further detailed analysis of investment returns may be found in the Investment Section.

Retirement system investments are managed to control the extent of downside risk to which assets are exposed while maximizing long-term gain potential. This positions the retirement system to limit the impact of adverse market conditions. Portfolio diversification by asset class and style is an important element of investment risk control.

Investment activity is governed by the "prudent person rule." The "prudent person rule" establishes a standard for all fiduciaries that includes anyone who has authority with respect to the retirement system. The "prudent person rule" states that fiduciaries shall discharge their duties solely in the interest of the retirement system participants and beneficiaries and with the degree of diligence, care, and skill that a prudent person would ordinarily exercise under similar circumstances.

The "prudent person rule" permits the Board to establish an investment policy based upon certain investment criteria and allows for the delegation of investment authority to professional investment managers. Investment constraints are outlined, including the appropriate degree of risk. Investment managers are hired to execute the investment policy. They have full discretion for investment decisions within statutory authority, Board policy, and their respective guidelines. A list of investment managers under contract with the retirement system as of December 31, 2005, is found on page 17 of this report. A summary of the total retirement system's assets can be found on page 64.

### *Historical Trends*

Accounting standards require that the "Statement of Plan Net Assets" state asset values at fair value and include only benefits and refunds due plan members and beneficiaries, and accrued investment and administrative expenses as of the reporting date. Information regarding the actuarial funding status of the Defined Benefit Plan is provided in the "Schedule of Funding Progress" (page 46). The asset value stated in the "Schedule of Funding Progress" is the actuarial value of assets as determined by calculating the ratio of market value to book value of assets over a five-year period. The funded ratio declined from 79% to

77% for the 2004 valuation. The decline, while slight, was expected. Investment losses from 2000-2002, combined with municipalities adopting better benefit plans, influenced the funded ratio. This percentage has declined over the last six years. The actuarial assumptions used in the most recent valuation are identified in the “Notes to the Schedules of Required Supplementary Information” (page 47).

Annual required employer contributions as determined by the actuary and the actual contributions made by employers are provided in the “Schedule of Employer Contributions” (page 46). This schedule indicates that employers are meeting their actuarially required contribution payments.

MERS’ overall financial condition improved for the fiscal year ended 2005, and the plan remains stable and viable for the years to come. The market upturn in 2005 and the downturns of 2000-2002 are historically considered to be normal market cycles in the overall economic process.

### ***Funding Status***

A pension plan is well funded when it has sufficient assets invested to meet all expected future obligations to participants. The greater the level of funding, the larger the ratio of assets to actuarial accrued liability. While the plan is not totally funded, annual contributions are being made at an actuarially determined rate to reach full funding. There is no single all-encompassing test for measuring a retirement system’s funding progress and current funded status. However, some common indicators of the progress that a retirement system has achieved in funding their obligations include observing the changes over time of the ratio of valuation assets to actuarial accrued liabilities, and the pattern of the unfunded actuarial accrued liability as a percentage of active payroll. These ratios and numbers are found in the Required Supplementary Information.

MERS Retirement Board has adopted funding methodology for the retirement system to achieve the following major objectives:

- Develop level required contribution rates as a percentage of payroll;
- Finance benefits earned by present employees on a current basis;
- Accumulate assets to enhance members’ benefit security;
- Produce investment earnings and interest on accumulated assets to help meet future benefit costs;
- Make it possible to estimate the long-term actuarial cost of proposed amendments to system provisions; and
- Assist in maintaining the retirement system’s long-term financial viability.

The actuarial method for calculating the accrued liability for all plans is Entry Age Normal with the objective of maintaining employer contributions approximately level as a percent of member payroll. A detailed discussion of the funding method is provided in the Actuarial Section of this report starting on page 69. Based upon the valuation results, MERS continues to be in sound financial health in accordance with actuarial principles of level percent of payroll financing.

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### STATEMENT OF PLAN NET ASSETS AS OF DECEMBER 31, 2005

|  | Defined<br>Benefit<br>Plan | Defined<br>Contribution<br>Plan |
|--|----------------------------|---------------------------------|
| <b>Assets</b>  |                            |                                 |
| Cash and Short-Term Investments                      | \$ 242,250,239             | \$ 23,989,935                   |
| Receivables  |                            |                                 |
| Employer Contributions                               | 23,443,765                 |                                 |
| Plan Member Contributions                            | 6,419,675                  |                                 |
| Sale of Investments                                  | 113,122,130                |                                 |
| Investment Income                                    | 11,384,979                 |                                 |
| Interfund Receivables                                | 434,593                    |                                 |
| Loans/Other  | 1,666,286                  | 1,497,500                       |
| Total Receivables                                    | 156,471,428                | 1,497,500                       |
| Investments, at fair value                           |                            |                                 |
| Domestic Fixed Income                                | 1,282,070,827              | 7,469,182                       |
| International Fixed Income                           | 216,862,161                |                                 |
| Domestic Equities                                    | 2,179,796,084              | 55,373,669                      |
| International Equities                               | 786,788,308                | 3,880,618                       |
| Real Estate  | 363,439,022                |                                 |
| Balanced Funds                                       |                            | 71,901,954                      |
| Total Investments                                    | 4,828,956,402              | 138,625,423                     |
| Invested Securities Lending Collateral               | 719,094,377                |                                 |
| Prepaid Expenses                                     | 433,475                    |                                 |
| Capital Assets, at cost, net of accum. depreciation  | 3,878,603                  |                                 |
| Total Assets   | 5,951,084,524              | 164,112,858                     |
| <b>Liabilities</b>                                   |                            |                                 |
| Purchase of Investments                              | 317,984,276                |                                 |
| Securities Lending Collateral                        | 719,094,377                |                                 |
| Administrative and Investment Costs                  | 6,563,876                  |                                 |
| Interfund Payables                                   |                            |                                 |
| Unspecified Contributions                            |                            |                                 |
| Total Liabilities                                    | 1,043,642,529              | -                               |
| <b>Net assets held in trust for pension benefits</b> | <b>\$ 4,907,441,995</b>    | <b>\$ 164,112,858</b>           |

The "Schedule of Funding Progress" is presented in the Required Supplementary Information in the Financial Section of this report. The accompanying notes are an integral part of these Financial Statements.

|                                   |                                      | December 31, 2005    |    | December 31, 2004    |  |
|-----------------------------------|--------------------------------------|----------------------|----|----------------------|--|
| Health Care<br>Savings<br>Program | Retiree Health<br>Funding<br>Vehicle | Total<br>Trust Funds |    | Total<br>Trust Funds |  |
| \$ 19,209                         | \$                                   | \$ 266,259,383       | \$ | 197,094,797          |  |
|                                   |                                      | 23,443,765           |    | 21,266,351           |  |
|                                   |                                      | 6,419,675            |    | 4,647,766            |  |
|                                   |                                      | 113,122,130          |    | 81,792,243           |  |
|                                   |                                      | 11,384,979           |    | 9,074,331            |  |
|                                   |                                      | 434,593              |    | 436,427              |  |
|                                   |                                      | 3,163,786            |    | 2,597,463            |  |
| -                                 | -                                    | 157,968,928          |    | 119,814,581          |  |
| 1,182,392                         | 3,642,991                            | 1,294,365,392        |    | 1,215,828,750        |  |
| 200,001                           | 616,212                              | 217,678,374          |    | 222,399,017          |  |
| 2,010,321                         | 6,193,869                            | 2,243,373,943        |    | 2,182,584,944        |  |
| 725,617                           | 2,235,651                            | 793,630,194          |    | 664,888,410          |  |
| 335,182                           | 1,032,708                            | 364,806,912          |    | 261,084,483          |  |
|                                   |                                      | 71,901,954           |    | 63,520,956           |  |
| 4,453,513                         | 13,721,431                           | 4,985,756,769        |    | 4,610,306,560        |  |
|                                   |                                      | 719,094,377          |    | 659,513,777          |  |
|                                   |                                      | 433,475              |    | 465,270              |  |
|                                   |                                      | 3,878,603            |    | 2,772,594            |  |
| 4,472,722                         | 13,721,431                           | 6,133,391,535        |    | 5,589,967,579        |  |
|                                   |                                      | 317,984,276          |    | 159,923,488          |  |
|                                   |                                      | 719,094,377          |    | 659,513,777          |  |
|                                   |                                      | 6,563,876            |    | 3,772,173            |  |
| 406,098                           | 28,495                               | 434,593              |    | 436,427              |  |
| 711                               |                                      | 711                  |    | 711                  |  |
| 406,809                           | 28,495                               | 1,044,077,833        |    | 823,646,576          |  |
| \$ 4,065,913                      | \$ 13,692,936                        | \$ 5,089,313,702     | \$ | 4,766,321,003        |  |

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### STATEMENT OF CHANGES IN PLAN NET ASSETS FOR THE YEAR ENDED DECEMBER 31, 2005

|  | Defined<br>Benefit<br>Plan | Defined<br>Contribution<br>Plan |
|--|----------------------------|---------------------------------|
| <b>Additions</b>                                     |                            |                                 |
| Contributions  |                            |                                 |
| Employer Contributions                               | \$ 207,123,552             | \$ 14,244,769                   |
| Plan Member Contributions                            | 71,324,903                 | 4,732,864                       |
| Transfers from Defined Benefit Plan                  |                            |                                 |
| Employer   |                            | 21,609                          |
| Plan Member  |                            | 964                             |
| Transfers from Other Plans and Other Items           |                            | 2,084,281                       |
| Total Contributions and Transfers                    | <u>278,448,455</u>         | <u>21,084,487</u>               |
| Investment Income                                    |                            |                                 |
| Net Appreciation in Fair Value of Plan               |                            |                                 |
| Investments  | 227,123,929                | 8,427,281                       |
| Interest Income                                      | 46,459,232                 |                                 |
| Dividend Income                                      | 29,773,002                 |                                 |
| Real Estate Operating Income, net                    | 4,538,596                  |                                 |
| Commission Recapture Income                          | 229,939                    |                                 |
|  | <u>308,124,698</u>         | <u>8,427,281</u>                |
| Less Investment Expenses                             | 16,500,475                 |                                 |
| Net Investment Income                                | <u>291,624,223</u>         | <u>8,427,281</u>                |
| From Security Lending Activities                     |                            |                                 |
| Security Lending Income                              | 22,620,518                 |                                 |
| Security Lending Expenses                            |                            |                                 |
| Borrower Rebates                                     | 19,951,189                 |                                 |
| Management Fees                                      | 533,538                    |                                 |
| Total Securities Lending Expenses                    | <u>20,484,727</u>          | <u>-</u>                        |
| Net Income from Security Lending Activities          | <u>2,135,791</u>           |                                 |
| Total Net Investment Income                          | <u>293,760,014</u>         | <u>8,427,281</u>                |
| Miscellaneous Income                                 | <u>6,020,448</u>           | <u>29,511,768</u>               |
|  | <u>578,228,917</u>         | <u>29,511,768</u>               |
| <b>Deductions</b>                                    |                            |                                 |
| Benefits   | 274,146,709                | 9,482,481                       |
| Refunds of Contributions                             |                            |                                 |
| Employer   |                            |                                 |
| Plan Member  | 4,157,567                  |                                 |
| Special Expenses and Fees                            | 398,690                    |                                 |
| Transfers to Defined Contribution Plan               |                            |                                 |
| Employer   | 21,609                     |                                 |
| Plan Member  | 964                        |                                 |
| Administrative Expense                               | 11,557,044                 |                                 |
|  | <u>290,282,583</u>         | <u>9,482,481</u>                |
|  | <u>287,946,334</u>         | <u>20,029,287</u>               |
| <b>Net Increase</b>                                  | <u>287,946,334</u>         | <u>20,029,287</u>               |
| <b>Net assets held in trust for pension benefits</b> |                            |                                 |
| Balance Beginning of Year                            | 4,619,495,661              | 144,083,571                     |
| Balance End of Year                                  | <u>\$ 4,907,441,995</u>    | <u>\$ 164,112,858</u>           |

The accompanying notes are an integral part of these Financial Statements.

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|                                   |                                      | Year Ended<br>December 31, 2005 |                  | Year Ended<br>December 31, 2004 |  |
|-----------------------------------|--------------------------------------|---------------------------------|------------------|---------------------------------|--|
| Health Care<br>Savings<br>Program | Retiree Health<br>Funding<br>Vehicle | Total<br>Trust Funds            |                  | Total<br>Trust Funds            |  |
| \$ 2,856,908                      | \$ 11,947,714                        | \$ 236,172,943                  | \$ 183,219,829   |                                 |  |
| 14,995                            |                                      | 76,072,762                      | 59,799,541       |                                 |  |
|                                   |                                      | 21,609                          | 320,682          |                                 |  |
|                                   |                                      | 964                             | 1,284            |                                 |  |
|                                   |                                      | 2,084,281                       | 5,356,930        |                                 |  |
| 2,871,903                         | 11,947,714                           | 314,352,559                     | 248,698,266      |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
| 165,081                           | 448,190                              | 236,164,481                     | 537,508,683      |                                 |  |
| 2,089                             |                                      | 46,461,321                      | 41,907,508       |                                 |  |
|                                   |                                      | 29,773,002                      | 23,447,373       |                                 |  |
|                                   |                                      | 4,538,596                       | 4,727,762        |                                 |  |
|                                   |                                      | 229,939                         | 478,380          |                                 |  |
| 167,170                           | 448,190                              | 317,167,339                     | 608,069,706      |                                 |  |
|                                   |                                      | 16,500,475                      | 12,061,649       |                                 |  |
| 167,170                           | 448,190                              | 300,666,864                     | 596,008,057      |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
|                                   |                                      | 22,620,518                      | 7,513,231        |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
|                                   |                                      | 19,951,189                      | 5,725,036        |                                 |  |
|                                   |                                      | 533,538                         | 446,856          |                                 |  |
| -                                 | -                                    | 20,484,727                      | 6,171,892        |                                 |  |
|                                   |                                      | 2,135,791                       | 1,341,339        |                                 |  |
| 167,170                           | 448,190                              | 302,802,655                     | 597,349,396      |                                 |  |
| 5,989                             |                                      | 6,026,437                       | 819,466          |                                 |  |
| 3,045,062                         | 12,395,904                           | 623,181,651                     | 846,867,128      |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
| 51,832                            | 95,470                               | 283,776,492                     | 253,918,782      |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
|                                   |                                      | -                               | 1,727,570        |                                 |  |
|                                   |                                      | 4,157,567                       | 3,525,082        |                                 |  |
|                                   |                                      | 398,690                         | 387,031          |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
|                                   |                                      | 21,609                          | 320,682          |                                 |  |
|                                   |                                      | 964                             | 1,284            |                                 |  |
| 250,436                           | 26,150                               | 11,833,630                      | 10,144,051       |                                 |  |
| 302,268                           | 121,620                              | 300,188,952                     | 270,024,482      |                                 |  |
| 2,742,794                         | 12,274,284                           | 322,992,699                     | 576,842,646      |                                 |  |
|                                   |                                      |                                 |                  |                                 |  |
| 1,323,119                         | 1,418,652                            | 4,766,321,003                   | 4,189,478,357    |                                 |  |
| \$ 4,065,913                      | \$ 13,692,936                        | \$ 5,089,313,702                | \$ 4,766,321,003 |                                 |  |

NOTES TO BASIC FINANCIAL STATEMENTS  
YEAR ENDED DECEMBER 31, 2005

***1. Reporting Entity and Plan Description***

The Municipal Employees' Retirement System of Michigan (MERS) is an agent multiple-employer, statewide, public employee pension plan created under Public Act 135 of 1945, repealed and replaced by successor Municipal Employees Retirement Act of 1984 (PA 427), as last amended by 2004 PA 490, and the MERS Plan Document, as revised. MERS was established to provide a pooled program for retirement, survivor and disability benefits on a voluntary basis to the State of Michigan's local government employees. The MERS Plan Document provides for Defined Benefit Plan, Defined Contribution Plan, Health Care Savings Program and a Retiree Health Funding Vehicle. See Notes 6 and 7 for the Defined Contribution Plan, Health Care Savings Program and Retiree Health Funding Vehicle (page 42-43).

Pursuant to 1996 PA 220, on August 15, 1996, MERS became an independent public non-profit corporation, which is an instrumentality of the participating municipalities and courts. Prior to that time MERS was a component unit of the State of Michigan and operated within the Department of Management and Budget. Since then, MERS is administered solely by a nine member Retirement Board consisting of the following members, each of whom, except for the retiree member and the Retirement Board appointees, shall be from a different county at the time of election:

Two members, who are appointed by the Retirement Board, who have knowledge or experience in retirement systems, administration of retirement systems, or investment management or advisory services.

One member, who is a retiree of the retirement system, is appointed by the Retirement Board.

Three members of the retirement system, who are officers of a participating municipality or of a participating court, who shall be elected as officer board members by the delegates to an annual meeting of the retirement system.

Three employee members of the retirement system, who are not officers of a participating municipality or of a participating court, who shall be elected as employee board members by the delegates to an annual meeting of the retirement system.

The regular term of office for members of the Retirement Board is three years. Members of the Retirement Board serve without compensation with respect to their duties, but are reimbursed by the retirement system for their actual and necessary expenses incurred in the performance of their duties.

**MERS PARTICIPATING MUNICIPALITIES AS OF DECEMBER 31, 2005**

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|                                   |                   |
|-----------------------------------|-------------------|
| Counties                          | 66                |
| Cities and Villages               | 252               |
| Townships                         | 74                |
| County Road Commissions           | 56                |
| Authorities, Districts and Others | 195               |
| Closed Groups                     | <u>16</u>         |
| Total                             | <u><u>659</u></u> |

Any “municipality” as that term is defined by Section 2b (2) of the Retirement Act, Michigan Compiled Law 38.1502b (2), within the State may elect to become a participating member of MERS by a majority vote of the municipality’s governing body or by an affirmative vote of the qualified electors. A municipality may elect to terminate participation by an affirmative vote of the qualified electors. Changes in benefit coverage are available to bargaining units after approval by a majority vote of the municipality’s governing body.

**MERS DEFINED BENEFIT MEMBERSHIP AS OF DECEMBER 31, 2005**

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|   |                      |
|---|----------------------|
| Retirees and Beneficiaries Currently Receiving Benefits |                      |
| Retirement annuities                                    | 15,826               |
| Survivor annuities                                      | 3,305                |
| Disability annuities                                    | <u>1,040</u>         |
| Total   | <u><u>20,171</u></u> |
| <br>  |                      |
| Vested former members                                   | 5,596                |
| <br>  |                      |
| Current active employees                                | <u>37,627</u>        |
| Total Membership  | <u><u>63,394</u></u> |

Benefit plans and provisions that are available for adoption are established by the Retirement Board. All benefits vest after six, eight or ten years of service depending on the plan adopted by the municipality’s governing body. The standard retirement age is 60 years. Municipalities may also adopt various other benefit plan options allowing retirement at an earlier age with unreduced benefits based upon combinations of age and years of service, or just years of service. Employees may retire after reaching several combinations of age and years of service to receive reduced early retirement benefits. MERS also provides nonduty disability and nonduty death benefits to employees after vesting requirements are met. The vesting requirements provision is waived for duty disability and duty death benefits. Benefits are paid monthly over the employee’s or survivor’s lifetime and are equal to a specific percentage of the employee’s final average compensation times the number of years of credited service. The specific percentage depends on the benefit plan or plans adopted by each municipality for its employees.

## FINANCIAL SECTION

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Pursuant to Article 9 Section 24 of the Constitution of the State of Michigan, “The accrued financial benefits of each pension plan and retirement system of the State and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby. Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing unfunded accrued liabilities.” Employees contribute to the retirement system at rates that range from 0 to 22.80% depending on the benefit plan adopted by the municipality. If an employee leaves employment or dies before becoming eligible for retirement benefits, accumulated employee contributions (plus interest) are refunded to the employee or designated beneficiary upon application.

The MERS programs have been determined to be a governmental plan that is a tax-qualified trust, under Internal Revenue Code Section 401(a), and tax exempt under Section 501(a). MERS most recent Letter of Favorable Determination was issued by IRS on June 15, 2005. These regulations include the preferential deferred taxability of contributions, accumulated earnings, pensions, annual compensation limits, and benefit limitations.

Under the Code, the major portion of a retiree’s pension is immediately taxable upon distribution. Pursuant to IRC Section 72(d), any “after tax contributions” are recovered tax-free over the life expectancy of the retiree (or beneficiary, if applicable).

IRC Section 401(a) (17) limits the amount of compensation that an active employee can receive for pension credit and, correspondingly, limits the amount of employer and employee contributions. Compensation in excess of the 401(a) (17) limit (currently \$210,000 for 2005 and increasing to \$220,000 in 2006) will not be credited by MERS. Contributions in excess of the IRS limit will not be collected or accepted, nor figure into final average compensation for benefit purposes.

In addition, IRC Section 415 imposes certain limitations on pension benefit payments. Any amounts that exceed the limitations shall be paid from a Qualified Excess Benefit plan Arrangement (QEBA), as authorized by IRC Section 415(m) and Michigan Compiled Law 38.1686. The QEBA shall be a separate portion of the plan, and is annually funded by the affected participating municipality or court. The Retirement Board established the MERS QEBA in 2003 solely for the purpose of providing to retirees and beneficiaries, that portion of the retirement allowance exceeding the Section 415 limits and otherwise not payable by the trust under the terms of the plan. Internal Revenue Service approval of the QEBA was pursuant to Private Letter Ruling issued December 15, 2003. Retirees and beneficiaries do not have an election, directly or indirectly, to defer compensation to the QEBA.

## **2. Summary of Significant Accounting Policies**

### ***Reporting Entity***

The Retirement Board is responsible for administration of the retirement system, has fiduciary responsibility for the investment of assets, and oversees all funds included in these financial statements. The Retirement Board appoints the Chief Executive Officer who manages and administers the retirement system under the supervision and direction of the Board.

Since MERS is an independent public corporation, MERS’ financial statements are not included in the financial statements of any other organization. MERS is the only entity included in this financial report.

The costs of administering the plan are allocated out to the municipalities along with investment gains and losses on a quarterly basis.

**Basis of Accounting**

The financial statements for MERS are prepared on the accrual basis in accordance with Generally Accepted Accounting Principles (GAAP). Employer and employee contributions are recognized when due pursuant to formal commitments, as well as statutory or contractual requirements. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

**GASB 27**

Governmental Accounting Standards Board (GASB) Statement No. 27, “Accounting for Pensions by State and Local Governmental Employers,” requires certain changes in reporting pensions by employers. The following section is required and pertains to MERS’ staff only. Prior to separation from the State of Michigan on August 15, 1996, the pension liability for MERS staff remained the obligation of its official employer, the State of Michigan. Therefore, MERS has no pension liability for staff prior to August 15, 1996, when it began independent payroll processing separate and apart from, the State.

The Retirement Board, as an employer, elected after separation in 1996 to become a participating municipality in MERS’ Defined Benefit Plan to provide pension benefits for MERS’ staff. Vesting occurs after 6 years of credited service. Normal retirement age is age 60, although an employee may retire at age 55 with 30 years of credited service. The annual pension benefit is calculated by multiplying the employee’s years of credited service by 2.25% and then multiplying it by the Final Average Compensation (FAC) based on the highest consecutive three years of compensation. MERS contributed 12.8% of compensation in 2005; employees contributed 2% of compensation in 2005.

The following pension information for GASB 27 applies to MERS’ staff only:

**SCHEDULE OF FUNDING PROGRESS**

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| Actuarial<br>Valuation<br>December 31 | Actuarial<br>Value of<br>Assets (a) | Actuarial<br>Accrued Liability<br>(AAL) (b) | Unfunded<br>(Over) AAL<br>(UAAL) (b-a) | Funded<br>Ratio<br>(a/b) | Covered<br>Payroll<br>(c) | UAAL as a %<br>of Covered<br>Payroll ((b-a)/c) |
|---------------------------------------|-------------------------------------|---|--|--------------------------|---------------------------|--|
| 2002                                  | 1,464,160                           | 1,652,199                                   | 188,039                                | 88.60                    | 2,305,146                 | 8.16   |
| 2003                                  | 2,012,358                           | 2,393,016                                   | 380,658                                | 84.10                    | 2,678,027                 | 14.21  |
| 2004                                  | 2,591,903                           | 3,694,402                                   | 1,102,499                              | 70.16                    | 3,603,548                 | 30.59  |

## FINANCIAL SECTION

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### ACTUARIAL ACCRUED LIABILITY FROM DECEMBER 31, 2004 AND DECEMBER 31, 2003 ACTUARIAL VALUATIONS

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|  | <b>2004</b>         | <b>2003</b>       |
|--|---------------------|-------------------|
| Retirees and beneficiaries currently receiving benefits  | \$ 376,442          | \$ 141,105        |
| Vested former members not yet receiving benefits   | 23,557              | 17,358            |
| Nonvested terminated employees (pending refunds of accumulated member contributions)   | 15,397              | 12,660            |
| Current employees  |                     |                   |
| Accumulated employee contributions, including allocated investment income  | 404,576             | 380,673           |
| Employer financed  | 2,874,430           | 1,841,220         |
| Total Actuarial Accrued Liability  | <u>3,694,402</u>    | <u>2,393,016</u>  |
| Net assets available for benefits at actuarial value (\$2,530,006 and \$1,837,500 at market value for December 31, 2004, and 2003, respectively) | 2,591,903           | 2,012,358         |
| Unfunded actuarial accrued liability   | <u>\$ 1,102,499</u> | <u>\$ 380,658</u> |

### THREE-YEAR TREND INFORMATION SCHEDULE OF EMPLOYER CONTRIBUTIONS

---

| <b>Fiscal<br/>Year Ended</b> | <b>Annual Pension<br/>Cost (APC)</b> | <b>Percentage of<br/>APC Contributed</b> | <b>Net Pension<br/>Obligation</b> |
|------------------------------|--------------------------------------|--|-----------------------------------|
| December 31, 2003            | \$ 162,168                           | 100%                                     | \$ -                              |
| December 31, 2004            | 192,024                              | 100%                                     | -                                 |
| December 31, 2005            | 259,500                              | 100%                                     | -                                 |

**Changes in Accounting Principles**

The plan adopted the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 40 issued in March 2003, “Deposit and Investment Risk Disclosures,” effective in 2005. Statement No. 40 modifies and adds certain investment reporting requirements previously established by GASB Statement No. 3, Deposits with Financial Institutions, Investments and Reverse Repurchase Agreements. Statement No. 40 has had an impact on the presentation of the notes to the financial statements, but no effect on net assets or the changes in net assets in the prior or current year.

**Fair Value of Investments**

In accordance with GASB 25, plan investments are presented at fair value. Short-term investments are valued at cost plus accrued interest, which approximates fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Corporate bonds not traded on a national or international exchange are based upon equivalent values of comparable securities with similar yield and risk. Independent appraisals are the basis for valuing the fair value of real estate. Other investments that do not have established markets are recorded at an estimated fair value.

**Capital Assets**

Leasehold improvements, office furniture, equipment, and software with a value of \$5,000 or more are carried at cost, less accumulated depreciation. The capital assets are depreciated using the straight-line method over the estimated useful lives of the related assets varying from three- to five-year spans. The table below is a schedule of the capital asset account balances as of December 31, 2004, and December 31, 2005, and changes to those account balances during the year ended December 31, 2005.

**CAPITAL ASSETS**

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| <b>Capital Assets</b>                           | <b>Leasehold<br/>Improvements</b> | <b>Office Furniture<br/>and Equipment</b> | <b>Software</b>            | <b>Total Capital<br/>Assets</b> |
|---|-----------------------------------|---|----------------------------|---------------------------------|
| Balances December 31, 2004                      | \$ 361,437                        | \$ 2,213,775                              | \$ 10,443,288              | \$ 13,018,500                   |
| Additions                                       |                                   | 114,397                                   | 2,712,133                  | 2,826,530                       |
| Balances December 31, 2005                      | <u>361,437</u>                    | <u>2,328,172</u>                          | <u>13,155,421</u>          | <u>15,845,030</u>               |
| <br>Accumulated Depreciation                    |                                   |   |                            |                                 |
| Balances December 31, 2004                      | 361,437                           | 1,588,315                                 | 8,296,154                  | 10,245,906                      |
| Depreciation Expense                            |                                   | 289,336                                   | 1,431,185                  | 1,720,521                       |
| Balances December 31, 2005                      | <u>361,437</u>                    | <u>1,877,651</u>                          | <u>9,727,339</u>           | <u>11,966,427</u>               |
| <br><b>Net capital assets December 31, 2005</b> | <b><u>\$ -</u></b>                | <b><u>\$ 450,521</u></b>                  | <b><u>\$ 3,428,082</u></b> | <b><u>\$ 3,878,603</u></b>      |

### **Total Columns on Statements**

“Total” columns on the “Statement of Plan Net Assets” and “Statement of Changes in Plan Net Assets” are presented to facilitate financial analysis. Amounts in these columns do not present the plan net assets and changes in plan net assets in conformity with the U.S. GAAP nor is such data comparable to a consolidation. Transactions between the Defined Benefit Plan and the Defined Contribution Plan have not been eliminated from the “Total” columns.

### **3. Contributions and Reserves**

#### **Contributions**

Contribution funding requirements are actuarially determined using the “entry age normal” actuarial cost method and are based upon the benefit plan adopted by the municipality. Some municipalities fund their entire pension obligations solely from employer contributions. Other municipalities jointly fund pension obligations from employee and employer contributions. Monthly employee contributions are based upon a percentage of actual compensation as determined by an annual actuarial valuation. Employer contributions are based upon projected compensation as determined by an annual actuarial valuation. Employee contributions are held in individual member accounts that are credited with interest annually; pursuant to Board Resolution adopted November 9, 2005, the rate for each year beginning in 2005 is the one year T-Bill rate as of December 1 each year for the ensuing December 31st employee interest calculation, and for interest calculations for the subsequent year for those employees requesting a refund of their contributions. The employee contribution rates vary from 0% to 22.80% according to the benefit plan adopted. See “Schedule of Employer Contributions” (page 46).

#### **Reserves**

Three Reserves have been established pursuant to the MERS Plan Document. See “Schedule of Changes in Reserves” (page 92).

- **Reserve for Employee Contributions:** Employee contributions and interest are credited to this reserve. Also credited to the reserve are monies received from the purchase of service credit and monies received in repayment of previously refunded contributions. The reserve is reduced by amounts paid to employees who terminate employment and request refunds and by amounts transferred into the “Reserve for Employer Contributions and Benefit Payments” upon an employee’s retirement. Interest is credited to each employee’s account, as provided in the Board’s November 9, 2005 Resolution. The reserve’s balance at year end December 31, 2005, is \$477,442,506. The “Reserve for Employee Contributions” was fully funded as of the December 31, 2004 MERS consolidated actuarial valuation.
- **Reserve for Employer Contributions and Benefit Payments:** All employer contributions are credited to this reserve. Net income is allocated to this reserve from the “Reserve for Expenses and Undistributed Income.” At retirement, an employee’s accumulated contributions, if any, including interest, are transferred into this reserve from the “Reserve for Employee Contributions.” Monthly benefits paid to retirees reduce this reserve. The December 31, 2005, balance is \$4,429,999,489.

The unfunded liability was \$1,433,404,485 (based on the actuarial value of assets) as of the December 31, 2004 MERS consolidated Actuarial Valuation.

- **Reserve for Expenses and Undistributed Investment Income:** All investment earnings and all other monies received that are not dedicated to other reserves are credited to this reserve. All administrative and investment expenses are paid from this reserve. Transfers from this reserve to the “Reserve for Employer Contributions and Benefit Payments” are at allocation rates determined by the Retirement Board. In 2005, the Retirement Board allocated 100% from the “Reserve for Expenses and Undistributed Investment Income” to the “Reserve for Employer Contributions and Benefit Payments,” leaving a zero balance at year end.

#### **4. Investments**

##### **Investments**

The Retirement Board has the fiduciary responsibility and authority to oversee the investment portfolio. Various professional investment managers are contracted to manage the retirement system’s assets. All investment decisions are subject to statutory regulations imposed under the Michigan Public Employees Retirement Systems Investment Act, 1965 PA 314, as amended, and the investment policy guidelines established by the Retirement Board. Michigan law allows diverse investment in stocks, corporate and government bonds, mortgages, real estate, alternative investments, and other investments. The Act sets forth prudent standards and requires that the assets of a retirement system be invested solely in the interest of the participants and beneficiaries. Under Plan Document Section 55(6), and 1965 PA 314, and Section 401(a)(2) of the Internal Revenue Code, the investments shall be made for the exclusive purpose of providing benefits to the participants and the participants’ beneficiaries, and defraying reasonable expenses of the retirement system.

The Retirement Board’s investment policy requires independent performance measurement of investment managers and establishes total return objectives for the total portfolio and major categories of investments. As of December 31, 2005, all securities held met the required statutory provisions and Retirement Board policy. As of the same dates, no investments were in default or subject to bankruptcy proceedings that had not been written down previously.

##### **Credit Risk**

Credit Risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to MERS. Credit risk exposure is dictated by each investment manager’s agreement. Each portfolio is managed in accordance with investment guidelines that are specific as to permissible credit quality ranges, exposure levels within individual security quality rating tiers, and/or the average credit quality of the overall portfolio.

As of December 31, 2005, the domestic fixed income portfolio consisted of the following fixed income investments with respective quality ratings, excluding those obligations of the U.S. Government. Investments issued by or explicitly guaranteed by the U.S. Government are not considered to have credit risk. The plan’s exposure to credit risk as of December 31, 2005, is presented on page 38, by investment category as rated by Standard & Poor’s.

# FINANCIAL SECTION

## CREDIT RATINGS SUMMARY - DECEMBER 31, 2005

| Quality Rating                     | Corporate Bonds | Bond Index Fund | Mortgages  | U.S. Agency Bonds | Global Fixed Income | Total         | % of Portfolio |
|------------------------------------|-----------------|-----------------|------------|-------------------|---------------------|---------------|----------------|
| AAA                                | 26,895,933      | 245,212,742     | 49,408,960 | 32,382,077        | 94,118,544          | 448,018,255   | 40%            |
| AA+                                | 1,043,700       |                 |            |                   | 3,600,802           | 4,644,502     | 0%             |
| AA                                 | 4,688,397       | 27,698,712      |            |                   | 8,090,346           | 40,477,455    | 4%             |
| AA-                                | 5,233,111       |                 |            |                   | 16,739,585          | 21,972,695    | 2%             |
| A+                                 | 28,715,138      |                 |            | 250,677           | 14,065,149          | 43,030,964    | 4%             |
| A                                  | 11,822,536      | 53,972,919      |            |                   | 34,915,906          | 100,711,361   | 9%             |
| A-                                 | 12,831,272      |                 |            |                   | 18,919,582          | 31,750,854    | 3%             |
| BBB+                               | 13,953,316      |                 |            |                   | 4,481,877           | 18,435,193    | 2%             |
| BBB                                | 19,820,302      | 64,221,443      |            |                   | 8,818,151           | 92,859,896    | 8%             |
| BBB-                               | 17,042,878      |                 |            |                   | 1,735,595           | 18,778,473    | 2%             |
| BB+                                | 15,692,032      |                 |            |                   | 1,028,535           | 16,720,568    | 1%             |
| BB                                 | 26,167,204      |                 |            |                   | 927,646             | 27,094,850    | 2%             |
| BB-                                | 38,641,290      |                 |            |                   | 908,254             | 39,549,544    | 4%             |
| B+                                 | 29,651,955      |                 |            |                   |                     | 29,651,955    | 3%             |
| B                                  | 32,498,197      |                 |            |                   | 629,880             | 33,128,077    | 3%             |
| B-                                 | 13,645,355      |                 |            |                   |                     | 13,645,355    | 1%             |
| CCC+                               | 4,045,680       |                 |            |                   |                     | 4,045,680     | 0%             |
| CCC                                | 524,025         | 830,961         |            |                   |                     | 1,354,986     | 0%             |
| CCC-                               | 3,830,705       |                 |            |                   |                     | 3,830,705     | 0%             |
| CC                                 |                 |                 |            |                   |                     | 0             | 0%             |
| C                                  |                 |                 |            |                   |                     | 0             | 0%             |
| D                                  | 1,639,793       |                 |            |                   |                     | 1,639,793     | 0%             |
| NR                                 | 102,197,770     | 3,759,112       | 13,469,899 |                   | 7,882,309           | 127,309,090   | 11%            |
| Totals                             | 410,580,589     | 395,695,889     | 62,878,859 | 32,632,754        | 216,862,161         | 1,118,650,251 | 100%           |
| U.S Government Bonds and Agencies* |                 |                 |            | 380,282,735       |                     | 380,282,735   |                |
| Fixed Income                       | 410,580,589     | 395,695,889     | 62,878,859 | 412,915,489       | 216,862,161         | 1,498,932,986 |                |

\* Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk.

**Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates, will adversely affect the fair value of an investment. Interest rate risk is controlled through diversification of portfolio management styles. Some investments' sensitivity to changing interest rates may derive from prepayment options embedded in an investment. Some corporate bonds with asset backed securities, collateralized mortgage obligations and mortgage backed securities are pass through securities that represent pooled debt obligations repackaged as securities that pass income and principal from debtors through the intermediary to investors. As of December 31, 2005, the Defined Benefit Plan exposure to interest rate risk as measured by the segmented time distribution maturity summary is listed below by investment class.

**SEGMENTED TIME DISTRIBUTION - DECEMBER 31, 2005**

| Investment Type     | Market Value            | Less than<br>1 Year  | 1 to 6 Years          | 6 to 10 Years         | 10+ Years             | Maturity not<br>Determined |
|---------------------|-------------------------|----------------------|-----------------------|-----------------------|-----------------------|----------------------------|
| Corporate Bonds     | \$ 410,580,589          | \$ 35,996,510        | \$ 124,223,525        | \$ 92,024,171         | \$ 73,774,908         | \$ 84,561,475              |
| Government Agencies | 305,542,091             | 17,996,056           | 19,287,242            | 31,760,500            | 111,666,839           | 124,831,454                |
| Government Bonds    | 107,373,398             | 3,783,457            | 14,535,303            | 61,627,361            | 27,427,277            | -                          |
| Global Fixed Income | 216,862,161             | 6,857,823            | 114,042,956           | 69,395,194            | 18,683,879            | 7,882,309                  |
| Mortgages           | 62,878,860              | -                    | 564,480               | 4,160,362             | 51,628,644            | 6,525,374                  |
| Bond Index *        | 395,695,889             |                      |                       |                       |                       | 395,695,889                |
| <b>Total</b>        | <b>\$ 1,498,932,988</b> | <b>\$ 64,633,846</b> | <b>\$ 272,653,506</b> | <b>\$ 258,967,588</b> | <b>\$ 283,181,547</b> | <b>\$ 619,496,501</b>      |

\* The Bond Index information on the segmented time distribution was unavailable. The effective duration in years for the Bond Index was 4.29 years. Effective duration is a measure of the price sensitivity of a debt investment to changes in interest rates. It is calculated based on the weighted average of the present value for all cash flows.

**Concentration of Credit Risk Debt Securities**

Concentration of credit risk is the risk of loss attributed to the magnitude of an entity's exposure in a single issuer. MERS Investment Policy states securities representing debt and equity of any one company shall not exceed 5 percent of the fair value of the plan's portfolio. MERS did not hold a single organization's securities that exceeded 5% of the plan's net assets available for benefits other than those issued or explicitly guaranteed by the U.S. Government as of December 31, 2005.

**Custodial Credit Risk for Investments**

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, MERS will not be able to recover the value of investments or collateral securities that are in the possession of an outside-third party. As of December 31, 2005, MERS had deposits of \$2,473,726 that were exposed to credit risk with The Northern Trust that were uninsured and uncollateralized. MERS also had Investment Securities and other investments of \$23,967,964 where the exposure to custodial credit risk was not determined.

**Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates, will adversely affect the fair value of an investment. MERS currency risk exposure, or exchange rate risk, is primarily derived from its holdings in foreign currency denominated equities, and fixed income investments.

MERS exposure to foreign currency risk in U.S. dollars as of December 31, 2005 is on page 40.

**FOREIGN CURRENCY RISK - DECEMBER 31, 2005**

| <b>Currency</b>   | <b>Equities</b>       | <b>Fixed Income</b>   | <b>Cash</b>         | <b>Total</b>            |
|---|-----------------------|-----------------------|---------------------|-------------------------|
| Australian dollar   | \$ 39,931,063         | \$ 21,609,278         | \$ 41,328           | \$ 61,581,669           |
| British pound sterling  | 73,748,796            | 29,060,254            | 592,093             | 103,401,143             |
| Canadian dollar   | 4,545,884             | 20,952,672            | 236,707             | 25,735,262              |
| Danish krone  | 3,779,520             | 21,752,535            | 865                 | 25,532,920              |
| Euro  | 121,769,461           | 51,625,066            | 2,583,892           | 175,978,419             |
| Hong Kong dollar  | 15,172,125            | 6,402,681             | 156,118             | 21,730,924              |
| Hungarian forint  |                       | 6,027,970             |                     | 6,027,970               |
| Indonesian rupiah   | 17                    |                       |                     | 17                      |
| Japanese yen  | 99,190,862            |                       | 90,219              | 99,281,081              |
| Malaysian ringgit   | 836,442               |                       | 4,726               | 841,168                 |
| Mexican peso  |                       | 6,601,664             | 270,626             | 6,872,290               |
| New Israeli shekel  |                       |                       | 207                 | 207                     |
| New Taiwan dollar   | 4,463,710             |                       | 27,651              | 4,491,361               |
| New Zealand dollar  | 4,849,225             | 10,968,516            | 191,746             | 16,009,486              |
| Norwegian krone   | 1,299,737             | 9,794,208             | 308                 | 11,094,253              |
| Polish zloty  |                       | 6,520,485             | 7,363               | 6,527,848               |
| Singapore dollar  | 2,828,981             |                       | 2,424               | 2,831,405               |
| South African rand  |                       | 6,544,762             | 241                 | 6,545,003               |
| South Korean won  | 2,391,819             |                       |                     | 2,391,819               |
| Swedish krona   | 1,323,716             | 10,782,422            | 308                 | 12,106,446              |
| Swiss franc   | 5,700,329             |                       | 1,881               | 5,702,210               |
| Turkish lira  | 3,702,813             |                       | 1,226               | 3,704,039               |
| <b>Total subject to foreign<br/>currency risk</b>                                       | <b>385,534,500</b>    | <b>208,642,513</b>    | <b>4,209,927</b>    | <b>598,386,940</b>      |
| <b>Investments in International<br/>Securities payable in<br/>United States dollars</b> | <b>401,253,809</b>    | <b>8,219,648</b>      |                     | <b>409,473,457</b>      |
| <b>Total International<br/>Investment Securities</b>                                    | <b>\$ 786,788,309</b> | <b>\$ 216,862,161</b> | <b>\$ 4,209,927</b> | <b>\$ 1,007,860,397</b> |

**Securities Lending**

MERS' policy authorizes participation in a securities lending program administered by its global custodian, The Northern Trust Company. MERS receives income as the owner of securities, as well as income from the lending of those securities. There are no dividends or coupon payments owing on the securities on loan. Securities lending earnings are credited to participating clients on approximately the fifteenth day of the following month. The securities loans are open contracts and, therefore, could be terminated at any time by either party.

The borrower collateralizes the loan with either cash or securities of 102% of market value plus accrued interest on domestic securities and 105% of market value plus accrued interest on international securities loaned. Cash open collateral is invested in a short-term investment pool, the Core Collateral Section, which had an average weighted maturity of 40 days as of December 31, 2005. Due to the nature of the program's collateralization of U.S. fixed income securities loans at 102% plus accrued interest, we believe that there is no credit risk per GASB 28 since the lender owes the borrower more than the borrower owes the lender. Cash collateral is invested for MERS in a dedicated short-term investment fund consisting of investment grade fixed income securities. The custodian provides for full indemnification to MERS for any losses that might occur in the event of borrower default resulting from negligence or intentional misconduct. Securities on loan are marked to market daily to ensure the adequacy of the collateral. There are no restrictions on the amount of securities that can be loaned at one time. Neither MERS nor the custodian has the ability to pledge or sell collateral securities delivered unless the borrower is in default.

MERS also invests in three commingled funds that participate in securities lending on a pooled basis.

MERS has never experienced a loss on securities lending transactions resulting from the default of a borrower or lending agent since it commenced lending securities in March 1995. The average number of days that MERS' securities were borrowed was approximately 81 days as of December 31, 2005, producing a net income of \$2,135,791 in 2005.

**COLLATERAL HELD AND FAIR VALUE OF SECURITIES ON LOAN  
AS OF DECEMBER 31, 2005**

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| Dollars In Thousands                |                         |                 |
|-------------------------------------|-------------------------|-----------------|
| Fair Value of<br>Securities on Loan | Nature of<br>Collateral | Collateral Held |
| \$ 697,030,426                      | Cash                    | \$ 719,094,377  |
| 59,521,862                          | Non-Cash                | 63,031,585      |
| \$ 756,552,288                      |                         | \$ 782,125,962  |

### **Derivatives and Structured Financial Instruments**

In accordance with investment policy, the active international managers may, when deemed prudent, enter into forward foreign currency exchange contracts to match settlement deadlines or to take advantage of favorable currency moves in the market. Forward contracts are used to hedge against changes in the exchange rates related to foreign equities, primarily denominated in European and Asian currencies. Forward currency contracts were used in the international large cap portfolio to hedge the United Kingdom sterling, the book cost as of December 31, 2005, was \$176,126,236 and the fair market value was \$239,775,497. This is used to reduce the risk of currency exposure in the portfolio.

Derivatives are neither used for speculation nor are they used to leverage the investment portfolio. The retirement system does not use swap agreements, stock options, caps/floors, or floating rate securities that are priced from underlying collateral. All derivatives are presented at fair value in the financial statements.

MERS uses futures contracts to equitize cash allocated to private equity markets that is awaiting investment. A futures contract is an agreement to buy or sell a specific amount of a commodity, currency, or financial instrument at a specified future date. Futures are exchange traded and the exchange assumes the risk of nonperformance by counterparty. MERS is required to pledge to the broker cash or U.S. government securities (the initial margin) equal to a certain percentage of the contract amount. The fair value of cash collateral was \$3,487,730 as of December 31, 2005. Subsequent payments, known as “variation margin,” are made or received by MERS each day, depending on the daily fluctuations in the value of the underlying security. Such variation margin is recorded as realized gain or loss in the financial statements. The fair value of the futures contract was \$47,055,000 as of December 31, 2005.

### **5. Commitments and Contingencies**

In the normal course of business, benefit claims by members or employers are in various stages of determination through established administrative procedures with the Retirement Board making the final decision, which may be subject to judicial review thereafter. MERS does not anticipate any material loss as a result of these claims. Furthermore, the cost of successful benefit claims is ultimately the responsibility of the affected municipality and becomes its funding obligation. MERS maintains insurance for workers’ compensation, owned and leased vehicles, blanket property, fiduciary, fidelity, and faithful performance to cover other risk of loss such as personal injury to employees or others, property damage, or other liability.

### **6. Defined Contribution Plan**

#### **Plan Description**

MERS’ Defined Contribution Plan became operative July 8, 1997, under Section 401(a) of the Internal Revenue Code. This date is that on which MERS Plan Document of 1996 was first determined by Internal Revenue Service Letter of Favorable Determination to meet qualification as a “governmental plan” trust under Code Section 401(a), and tax exempt under Section 501(a). MERS has contracted with International

City Management Association Retirement Corporation (ICMA-RC) to serve as the third-party administrator for the plan. The plan is available to all MERS' participating municipalities and may be adopted on a division-by-division basis. Plan provisions and requirements are specified in the MERS Plan Document.

Contributions to the Defined Contribution Plan are remitted directly to ICMA-RC by the participating municipalities and are separate from contributions made to the MERS' Defined Benefit Plan. Both employer contributions and employee voluntary contributions are governed by the percentages allowable under the Internal Revenue Code. Employees electing to be in the Defined Contribution Plan may not change their contribution as a percent of payroll after enrollment. Participating municipalities may upon adoption of a Defined Contribution resolution for new hires offer current Defined Benefit Plan employees an opportunity to opt into the Defined Contribution Plan. MERS then transfers the actuarial present value of the employee's accrued benefit in the Defined Benefit Plan into the employee's account in the Defined Contribution Plan (at a stipulated funded ratio that shall not exceed 100%). Employees direct their contributions to various investment options offered by ICMA-RC and may transfer their account balances between investment categories or make changes to the percentage allocation on a daily basis. As of December 31, 2005, there were 107 plans that had adopted the Defined Contribution Plan with 7,393 member accounts totaling \$164.1 million.

ICMA-RC offers a variety of investment opportunities for the Defined Contribution Plan. The Vantage Trust Funds include nine actively managed funds, five index funds, and five model portfolio funds. The Mutual Fund Series includes 14 segregated accounts, each with a different investment strategy.

### **Significant Accounting Policies**

The Defined Contribution Plan financial statements are prepared using a cash basis of accounting (which approximates the accrual basis of accounting). Plan investments are presented at fair value. Plan participants select from 35 investment options.

### **Reserve for Defined Contribution Plan**

All additions to and deductions from the Defined Contribution Plan are recorded in this reserve. ICMA-RC maintains the individual employee account records.

## ***7. MERS Health Trust Programs***

On January 13, 2004, MERS received a Private Letter Ruling allowing establishment of an Internal Revenue Code Section 115 "Integral Governmental Trust." MERS created two programs from this trust, the Health Care Savings Program and the Retiree Health Funding Vehicle.

### **A. Health Care Savings Program**

#### **Plan Description**

The MERS Health Care Savings Program is available to all municipalities in Michigan and became operational in June of 2004. The employer sponsored program provides medical reimbursement accounts to

the participating employees for reimbursement of their medical expenses, as defined in Code Section 213, once they terminate employment, are on medical leave for six months or longer, or are on disability from any public pension plan. There are four types of contributions that may be used in the program: 1. Basic Employer (tax-favored); 2. Mandatory Salary Reductions (tax-favored), 3. Mandatory Leave Conversions (tax-favored) and 4. Voluntary Employee Contributions (post-tax). As a result of the Private Letter Ruling, Code Section 213 reimbursements are tax-exempt for the employee, their spouse, and/or Code Section 152 dependent(s). The Health Care Savings Program accounts are invested in the MERS Total Market Fund portfolio and earnings are tax exempt as a result of the MERS Private Letter Ruling. Plan provisions and requirements are specified in the MERS Health Care Savings Program and Retiree Health Funding Vehicle Plan Document, and Trust.

### **Significant Accounting Policies**

The Health Care Savings Program financial statements are prepared using a cash basis of accounting (which approximates the accrual basis of accounting). Plan investments are presented at fair value. Contributions are pooled on a commingled basis subject to the Public Employee Retirement System Investment Act (“PERSIA”), 1965 PA 314, and pursuant to the Public Employee Health Care Fund Investment Act, 1999 PA 149.

### **Reserve for Health Care Savings Program**

All additions to and deductions from the Health Care Savings Program are recorded in this reserve. MERS maintains the separate individual member account records.

## **B. Retiree Health Funding Vehicle**

### **Plan Description**

The MERS Retiree Health Funding Vehicle is available to all municipalities in Michigan and became operational in the fall of 2004. Participating municipalities can contribute monies to the Trust and no contribution method other than “pay as you go” cash funding is required or imposed on the participating employer. These funds constitute a health care fund, which enable municipalities to accumulate funds to provide or subsidize health benefits for retirees and beneficiaries as defined by Code Section 213. The Retiree Health Funding Vehicle accounts are invested in the MERS Total Market Fund portfolio and earnings are tax exempt as a result of the MERS Private Letter Ruling. Plan provisions and requirements are specified in the MERS Health Care Savings Program and Retiree Health Funding Vehicle Plan Document, and Trust.

### **Significant Accounting Policies**

The Retiree Health Funding Vehicle financial statements are prepared using a cash basis of accounting (which approximates the accrual basis of accounting). Plan investments are presented at fair value. Contributions are pooled on a commingled basis subject to 1965 PA 314, and 1999 PA 149.

**Reserve for Retiree Health Funding Vehicle**

All additions to and deductions from the Retiree Health Funding Vehicle are recorded in this reserve. MERS maintains the separate municipality employer account records.

**8. Interfund Receivables and Payables**

The Defined Benefit Plan, Health Care Savings Program, and the Retiree Health Funding Vehicle are separate trusts with their own general ledgers and financial statements. Interfund receivables and payables have been created as an avenue for the Defined Benefit Plan to handle all transactions for the various funds.

As of December 31, 2005, interfund receivables and payables were:

**INTERFUND RECEIVABLES AND PAYABLES**

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|                                | <u>Interfund<br/>Receivables</u> | <u>Interfund<br/>Payables</u> |
|--------------------------------|----------------------------------|-------------------------------|
| Defined Benefit Plan           | \$ 434,593                       |                               |
| Defined Contribution Plan      |                                  |                               |
| Health Care Savings Program    |                                  | 406,098                       |
| Retiree Health Funding Vehicle |                                  | 28,495                        |
| Totals                         | <u>\$ 434,593</u>                | <u>\$ 434,593</u>             |

REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF FUNDING PROGRESS

(Dollars in Millions)

| Actuarial<br>Valuation<br>December 31 | Actuarial<br>Value of<br>Assets (a) | Actuarial<br>Accrued Liability<br>(AAL) (b) | Unfunded<br>(Over) AAL<br>(UAAL) (b-a) | Funded<br>Ratio<br>(a/b) | Covered<br>Payroll<br>(c) | UAAL as a %<br>of Covered<br>Payroll ((b-a)/c) |
|---------------------------------------|-------------------------------------|---|--|--------------------------|---------------------------|--|
| 1999                                  | \$ 3,464.9                          | \$ 3,835.5                                  | \$ 370.6                               | 90.30%                   | \$ 1,179.3                | 31.40%   |
| 2000                                  | 3,787.2                             | 4,397.0                                     | 609.8                                  | 86.10                    | 1,226.0                   | 49.70  |
| 2001                                  | 4,034.4                             | 4,783.9                                     | 749.5                                  | 84.30                    | 1,271.6                   | 58.90  |
| 2002                                  | 4,133.0                             | 5,181.2                                     | 1,048.2                                | 79.80                    | 1,327.4                   | 79.00  |
| 2003                                  | 4,459.5                             | 5,667.7                                     | 1,208.2                                | 78.70                    | 1,381.2                   | 87.50  |
| 2004                                  | 4,731.4                             | 6,164.8                                     | 1,433.4                                | 76.70                    | 1,437.2                   | 99.80  |

SCHEDULE OF EMPLOYER CONTRIBUTIONS

(Dollars in Millions)

| Fiscal Year<br>(See Note 1) | Annual<br>Required<br>Contribution | Accelerated<br>Funding<br>Credit | Percentage<br>Contributed<br>Before Credit | Percentage<br>Contributed<br>After Credit |
|-----------------------------|------------------------------------|----------------------------------|--|---|
| 1999                        | 120                                | 7                                | 111%                                       | 118%                                      |
| 2000                        | 125                                | 8                                | 106  | 113                                       |
| 2001                        | 118                                | 15                               | 103  | 118                                       |
| 2002                        | 125                                | 8                                | 102  | 109                                       |
| 2003                        | 133                                | 5                                | 121  | 125                                       |
| 2004                        | 156                                | 2                                | 108  | 109                                       |
| 2005                        | 170                                | 0                                | 122  | 122                                       |

See notes to the Schedules of Required Supplementary Information.

**REQUIRED SUPPLEMENTARY INFORMATION**  
**NOTES TO THE SCHEDULES OF REQUIRED SUPPLEMENTARY INFORMATION**

- 1. Actuarial Valuation** - Actuarial valuations are prepared annually as of December 31 for each participating municipality. To facilitate budgetary planning needs, employer contribution requirements are provided for each municipality’s unique fiscal year that commences after the following calendar year end. For example, the contribution requirements for fiscal years that began in 2005 were determined by actuarial valuations as of December 31, 2003.

Approximately 75% of the participating municipalities have fiscal years that begin January 1 or July 1.

The “Annual Required Contribution” and “Accelerated Funding Credit” shown in the preceding schedule represent the summation of each participating municipality’s contribution requirements for its fiscal year commencing in the year stated. However, the calculations to determine the Percentage Contributed use contributions recorded during MERS’ fiscal year.

- 2. Accelerated Funding Credits** - An Accelerated Funding Credits (AFC) Program was first established by the Retirement Board in 1984, and has since been modified several times. The program reduced required contribution rates of municipalities with funded percentages in excess of 100%. The program was discontinued beginning with fiscal years starting in 2005.
- 3. Summary of Actuarial Methods and Assumptions** - The information presented in the required supplementary schedules was determined as part of the actuarial valuation at the dates indicated. Additional information as of the latest actuarial valuation may be found in the Actuarial Section.

Summary Information as follows:

|                                      |  |
|--------------------------------------|--|
| <i>Valuation Date</i>                | December 31, 2004  |
| <i>Actuarial Cost Method</i>         | Entry Age Normal   |
| <i>Amortization Method</i>           | Level Percent of Payroll, Open   |
| <i>Remaining Amortization Period</i> | 30 years for positive unfunded liabilities and 10 years for negative unfunded liabilities. For divisions that are closed to new hires, the amortization period for positive unfunded liabilities is decreased annually by 2 years until the period reaches 5 years. Beginning in 2006, there will be a gradual reduction of the amortization period for open divisions from 30 years to 25 years |

## FINANCIAL SECTION

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### *Asset Valuation Method*

5-Year Smoothed Market (For 2003, the Retirement Board adopted a one time ad hoc adjustment to aggregate the yet unrecognized market gains and losses from 1999-2002 with the 2003 market gain. No gain or loss was recognized for 2003. The aggregate loss amount of \$388,778,035 was to be recognized in four equal dollar installments in 2004-2007.) In 2006 a 10-year Smoothed Market Asset Valuation Method will be implemented.

### *Actuarial Assumptions*

|                            |  |
|----------------------------|--|
| Investment Rate of Return  | 8%   |
| Projected Salary Increases | 4.5% for base inflation, plus 0.0% to 8.4% per year attributable to merit and longevity. |
| Post-Retirement Benefit    | 2.5% annual post-retirement benefit adjustments if adopted by individual municipality.   |

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**SCHEDULE OF ADMINISTRATIVE EXPENSES FOR THE YEAR ENDED DECEMBER 31, 2005**


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|                                      |                                    |
|--------------------------------------|------------------------------------|
| <b>Administrative Expenses</b>       |                                    |
| Personnel Services                   |                                    |
| Salaries                             | \$ 3,539,976                       |
| Social Security                      | 270,944                            |
| Retirement                           | 463,932                            |
| Insurance                            | 539,956                            |
| Total Personnel Services             | <u>4,814,808</u>                   |
| Professional Services                |                                    |
| Actuarial Services                   | 734,893                            |
| Audit Services                       | 74,000                             |
| Commercial Banking                   | 101,175                            |
| Legal Services                       | 186,560                            |
| Medical Advisory Services            | 49,841                             |
| Consultants                          | 163,153                            |
| Computer Maintenance                 | 15,493                             |
| Total Professional Services          | <u>1,325,115</u>                   |
| Communications                       |                                    |
| Copying                              | 76,358                             |
| Library Records                      | 77,058                             |
| Mail & Postage                       | 129,501                            |
| Promotional Supplies                 | 9,784                              |
| Telephone / Communications           | 84,955                             |
| Travel and Meetings                  | 169,689                            |
| Annual Meeting                       | 223,325                            |
| Total Communications                 | <u>770,670</u>                     |
| Rentals                              |                                    |
| Equipment Rental                     | 148,298                            |
| Office Rental                        | 604,500                            |
| Total Rentals                        | <u>752,798</u>                     |
| Miscellaneous                        |                                    |
| Payroll Processing                   | 7,800                              |
| Office Supplies                      | 86,574                             |
| Operating Expenses                   | 760,223                            |
| Equipment Expenses                   | 86,756                             |
| Software                             | 53,895                             |
| Software Maintenance                 | 506,731                            |
| Professional Development & Tuition   | 255,569                            |
| Insurance                            | 194,578                            |
| Maintenance                          | 241,346                            |
| Depreciation                         | 1,700,181                          |
| Total Miscellaneous                  | <u>3,893,653</u>                   |
| <b>Total Administrative Expenses</b> | <b><u><u>\$ 11,557,044</u></u></b> |

## FINANCIAL SECTION

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### SCHEDULE OF INVESTMENT EXPENSES FOR THE YEAR ENDED DECEMBER 31, 2005

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#### Investment Expenses

|                                  |           |                                 |
|----------------------------------|-----------|---------------------------------|
| Personnel Services               |           |                                 |
| Salaries                         | \$        | 248,949                         |
| Social Security                  |           | 34,223                          |
| Retirement                       |           | 58,527                          |
| Insurance                        |           | 65,153                          |
| Total Personnel Services         |           | <u>406,852</u>                  |
| <br>                             |           |                                 |
| Professional Services            |           |                                 |
| Commercial Banking               |           | 362,989                         |
| Investment Managers              |           | 15,399,522                      |
| Investment Performance Expense   |           | 66,500                          |
| Other Consultants                |           | 6,200                           |
| Total Professional Services      |           | <u>15,835,211</u>               |
| <br>                             |           |                                 |
| Communication                    |           |                                 |
| Travel-Nontaxable                |           | 30,524                          |
| Travel-Taxable                   |           | 40                              |
| Total Communication              |           | <u>30,564</u>                   |
| <br>                             |           |                                 |
| Miscellaneous                    |           |                                 |
| Operating Expenses               |           | 72,325                          |
| Equipment Expense                |           | 8,132                           |
| Software Maintenance             |           | 127,051                         |
| Depreciation                     |           | 20,340                          |
| Total Miscellaneous              |           | <u>227,848</u>                  |
| <br>                             |           |                                 |
| <b>Total Investment Expenses</b> | <b>\$</b> | <b><u><u>16,500,475</u></u></b> |

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**SCHEDULE OF PAYMENTS TO CONSULTANTS FOR THE YEAR ENDED DECEMBER 31, 2005**


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| <b>Firm</b>                          | <b>Nature of Service</b>               | <b>Fee</b>                 |
|--------------------------------------|--|----------------------------|
| Gabriel, Roeder, Smith & Company     | Actuary and System Implementation      | \$ 2,971,023               |
| PeopleSoft / Oracle                  | Systems Implementation and Maintenance | 449,740                    |
| Ice Miller                           | Legal Counsel                          | 146,228                    |
| SunGard                              | Disaster Recovery                      | 67,709                     |
| Andrews, Hooper & Pavlik P.L.C.      | Auditor                                | 45,000                     |
| Consulting Physicians                | Medical Advisors                       | 43,758                     |
| Zephyr Associates                    | Investment Hedge Fund / Software       | 37,500                     |
| New London Management Associates     | Personnel and Human Resource Advisors  | 33,007                     |
| Technology Advisors                  | Software                               | 31,218                     |
| Karoub Associates                    | Legislative Advisors                   | 30,000                     |
| Cost Effectiveness Measurement Inc.  | Benchmarking Analysis                  | 30,000                     |
| Service Express, Inc                 | Hardware Maintenance                   | 22,590                     |
| Evestment Alliance, LLC              | Investment Analytics System            | 11,000                     |
| <b>Total Payments to Consultants</b> |  | <u><u>\$ 3,918,773</u></u> |

Note: Fees paid to investment managers are included in the Investment Section.

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*“Of Michigan’s total land area of 36 million acres, over 18 million acres are today classed as forest and wildland, more than one-third of which is in public ownership, mostly in state and national forests, wildlife areas and parks, with state ownership comprising over 4 million acres, and federal ownership nearly 3 million.”*

*Norman F. Smith*

*“Trees of Michigan and the Upper Great Lakes”*

*Publisher: Samuel Speigel, Thunder Bay Press*

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