

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM

Annual Financial Report

June 30, 2018



ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
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Arkansas

Sen. Jason Rapert
Senate Chair
Sen. Eddie Cheatham
Senate Vice Chair



Rep. Richard Womack
House Chair
Rep. DeAnn Vaught
House Vice Chair

Roger A. Norman, JD, CPA, CFE, CFF
Legislative Auditor

LEGISLATIVE JOINT AUDITING COMMITTEE ARKANSAS LEGISLATIVE AUDIT

INDEPENDENT AUDITOR'S REPORT

Arkansas State Highway Employees Retirement System
Legislative Joint Auditing Committee

Report on the Financial Statements

We have audited the accompanying financial statements of the fiduciary pension trust fund of the Arkansas State Highway Employees Retirement System, an office of Arkansas state government, as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Arkansas State Highway Employees Retirement System's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the fiduciary pension trust fund of the Arkansas State Highway Employees Retirement System as of June 30, 2018, and the changes in financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As indicated above, the financial statements of the Arkansas State Highway Employees Retirement System are intended to present the financial position and the changes in financial position of only that portion of the fiduciary pension trust fund of the State that is attributable to the transactions of the Arkansas State Highway Employees Retirement System. They do not purport to, and do not, present fairly the financial position of the State as of June 30, 2018, or the changes in its financial position for the year then ended, in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the required supplementary information, listed in the accompanying table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board (GASB), which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

The GASB requires that a Management's Discussion and Analysis be presented to supplement government-wide financial statements. However, as discussed in the "Emphasis of Matter" paragraph above, the financial statements of the Arkansas State Highway Employees Retirement System are only for the specific transactions and activity of the Agency and not for the State as a whole. Therefore, the Management's Discussion and Analysis is not required to be presented for the Arkansas State Highway Employees Retirement System individually. Our opinion on the basic financial statements is not affected by the omission of this information.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Arkansas State Highway Employees Retirement System's basic financial statements. The Schedule of Selected Information is presented for purposes of additional analysis and are not a required part of the basic financial statements.

The Schedule of Selected Information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on this information.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated April 26, 2019, on our consideration of the Arkansas State Highway Employees Retirement System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely 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 effectiveness of the Arkansas State Highway Employees Retirement System's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Arkansas State Highway Employees Retirement System's internal control over financial reporting and compliance.

ARKANSAS LEGISLATIVE AUDIT



Roger A. Norman, JD, CPA, CFE, CFF
Legislative Auditor

Little Rock, Arkansas
April 26, 2019
SA0509118

Arkansas

Sen. Jason Rapert
Senate Chair
Sen. Eddie Cheatham
Senate Vice Chair



Rep. Richard Womack
House Chair
Rep. DeAnn Vaught
House Vice Chair

Roger A. Norman, JD, CPA, CFE, CFF
Legislative Auditor

LEGISLATIVE JOINT AUDITING COMMITTEE ARKANSAS LEGISLATIVE AUDIT

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

INDEPENDENT AUDITOR'S REPORT

Arkansas State Highway Employees Retirement System
Legislative Joint Auditing Committee

We have audited, 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, the financial statements of the fiduciary pension trust fund of the Arkansas State Highway Employees Retirement System (the "Agency"), an office of Arkansas state government, as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Arkansas State Highway Employees Retirement System's basic financial statements, and have issued our report thereon dated April 26, 2019.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies; therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in the accompanying Schedule of Findings and Responses as items 2018-1, that we consider to be a significant deficiency.

Compliance and Other Matters

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

SCHEDULE OF FINDINGS AND RESPONSES

2018-1

A review of securities lending activity as reported by the Plan's custodial bank, Northern Trust, and related GASB statements for the accounting and financial reporting for securities lending transactions revealed lending activity occurring in fiscal year 2018 that was not properly reported by the System. GASB Statement No. 28 requires that government lenders report an asset and a liability in connection with security lending transactions when these transactions are collateralized with cash or with securities that may be pledged or sold without a default by the broker-dealer. Failure to report information about securities lending activity caused assets to be understated by \$44,216,330 and liabilities to be understated by \$44,214,887. In addition, the \$1,443 of realized gain was not included as an increase in the fair value of investments at year-end.

We recommend the Agency review investment transactions, specifically those relating to securities lending activities, as well as the guidelines surrounding accounting and financial reporting for securities lending transactions to ensure all securities lending activity is properly recorded.

Management personnel responded: *Securities lending was a new area of income for the System. Although we were able to reconcile with the custodial bank, more care should have been applied when determining the proper method of posting activities to ensure compliance with GASB. Since this has been brought to our attention, we have had correspondence with the custodial bank to better understand the reporting of the securities lending program and to receive additional reporting on a monthly basis.*

Agency's Response to Findings

The Agency's response to the finding identified in our audit is described above. The Agency's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose. However, pursuant to Ark. Code Ann. § 10-4-417, all reports presented to the Legislative Joint Auditing Committee are matters of public record, and distribution is not limited.

ARKANSAS LEGISLATIVE AUDIT



Tom Bullington, CPA
Deputy Legislative Auditor

Little Rock, Arkansas
April 26, 2019

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
STATEMENT OF FIDUCIARY NET POSITION
JUNE 30, 2018

Exhibit A

	Total
ASSETS	
Cash and cash equivalents	\$ 169,931,032
Receivables:	
Member contributions	245,653
Employer contributions	427,411
Accrued investment income	1,718,016
Other	5,636,506
Total Receivables	8,027,585
Investments, at fair value:	
U.S. Government obligations	50,800,131
Government agency securities	4,352,561
Domestic equities	808,517,206
International equities	97,735,320
Corporate obligations	162,490,083
Municipal bonds	11,900,257
Mutual and exchange traded funds	91,924,146
Mortgage-backed securities	3,179,033
Master limited partnerships	72,240,472
Total Investments	1,303,139,209
Securities lending collateral	44,216,330
TOTAL ASSETS	1,525,314,156
LIABILITIES	
Accrued expenses and other current liabilities	8,580,534
Securities lending liability	44,214,887
	52,795,421
DEFERRED INFLOWS OF RESOURCES	
Related to revenues	44,427
NET POSITION RESTRICTED FOR PENSIONS	\$ 1,472,474,308

The accompanying notes are an integral part of these financial statements.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
STATEMENT OF CHANGES IN FIDUCIARY NET POSITION
FOR THE YEAR ENDED JUNE 30, 2018

Exhibit B

	Total
ADDITIONS	
Contributions:	
Employer	\$ 19,294,283
Member	9,163,177
Total Contributions	28,457,460
Investment income	
From investing activities:	
Net appreciation (depreciation) in fair value of investments	187,855,989
Interest	8,117,814
Dividends	17,429,510
Total Investment Income (Loss)	213,403,313
Less investment expense	(8,257,292)
Net Investment Income (Loss)	205,146,021
From securities lending activities:	
Securities lending gross income	853,574
Less securities lending expense	(500,878)
Net securities lending income (Loss)	352,696
Other additions	364
TOTAL ADDITIONS	233,956,541
DEDUCTIONS	
Benefits	113,476,915
Refunds of contributions	2,270,815
Administrative expenses	55,703
TOTAL DEDUCTIONS	115,803,433
NET INCREASE (DECREASE) IN NET POSITION	118,153,108
NET POSITION - BEGINNING OF YEAR	1,354,321,200
NET POSITION - END OF YEAR	\$ 1,472,474,308

The accompanying notes are an integral part of these financial statements.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies

A. Reporting Entity/History

Act 454 of 1949, as amended, established the Arkansas State Highway Employees Retirement System (the System), as an office of Arkansas state government, to provide uniform retirement eligibility and benefits for employees of the Arkansas Department of Transportation. This Act also provides for a seven-member Board of Trustees to administer the System. The members include the Director of State Highways and Transportation, the Treasurer of State, the Director of the Department of Finance and Administration, and the Chief Engineer of the Arkansas Department of Transportation. Two of the remaining Board members are elected by the active members for two-year terms, and one retired member is elected by retirees and active members in the Deferred Retirement Option Program (DROP). An election is held each June to replace any member whose term is expiring. Board members serve without pay but are entitled to receive reimbursement for all actual expenses incurred while performing official duties of the Board. Act 793 of 1977 established minimum financing, accounting, and reporting standards for the System.

B. Plan Description

The Arkansas State Highway Employees Retirement System (ASHERS), a single employer defined benefit pension plan, covers all employees of the Arkansas Department of Transportation. On June 30, 2018, System membership consisted of the following:

Retirees and beneficiaries currently receiving benefits, including DROP participants	3,805
Inactive members entitled to but not yet receiving benefits	211
Active members	<u>3,343</u>
Total	<u><u>7,359</u></u>

The plan may only be amended by the Arkansas General Assembly.

The State (or employer) contributes 12.9% of pay for each covered employee not in the DROP. The State does not make contributions on employees in Tier I of DROP but contributes 6.9% of pay on employees in Tier II of DROP. Each covered employee not currently in Tier I of DROP must make member contributions equal to 6% of compensation (including members in Tier II DROP).

Members are eligible for full retirement benefits under the following conditions:

- 1) At age 65 with five or more years of service.
- 2) At age 62 with 15 or more years of service.
- 3) At age 60 with 20 or more years of service.
- 4) At any age with 28 or more years of service.

A member may retire with a reduced benefit at age 55 with five years of service. The plan also provides for reciprocal service, purchase of service, and disability and survivor benefits.

The retirement benefit, paid monthly, is determined based on (1) the member's final average salary (an average of the highest 36 consecutive months' salary) and (2) the number of years and months of credited service.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

B. Plan Description (continued)

Retiree benefit increases are calculated each year on July 1 for the following 12 months. The redetermined amount shall be the amount of the benefit payable as of June 30 each year, increased by a percentage calculated using the Consumer Price Index for Urban Wage Earners & Clerical Workers for the one-year period ending December of the previous calendar year. The increase is capped at 3%, and calculated benefits for the next year will not be less than the previous year.

C. Basis of Presentation – Fund Accounting

The accounting system is organized and operated on a fund basis. A *fund* is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances and changes therein, which are segregated for purposes of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. The following types of funds, if applicable to this Agency, are recognized in the accompanying financial statements.

Fiduciary Funds

Trust and Agency Funds – Trust and Agency Funds are used to report resources held by the Agency in a trustee capacity or as an agent for individuals, other governmental units, and other funds. These include Pension Trust Funds, Employee Health Trust Funds, Investment Trust Funds, Private-Purpose Trust Funds, and Agency Funds. The specific activity accounted for at this Agency includes the following:

Arkansas State Highway Employees Retirement System Fiduciary Pension Trust Fund

D. Basis of Accounting

Basis of accounting refers to when revenues and expenditures or expenses are recognized and reported in the financial statements. The economic resources measurement focus and accrual basis of accounting are used in all Fiduciary Fund financial statements. Under the accrual basis, contributions and other revenues are recognized when earned. Benefits paid, refunds, and other expenses are recorded when due and payable in accordance with the provisions of the law.

E. Federal Income Tax Status

During the year ended June 30, 2018, the System qualified under 26 USC § 401(a) and was exempt from federal income taxes under 26 USC § 501(a).

F. Cash and Cash Equivalents

Cash and cash equivalents include demand accounts, cash in State Treasury, and all short-term instruments with maturities at purchase of 90 days or less. The short-term investment fund (STIF) is created through daily sweeps of excess cash by the custodial bank and is invested in U.S. Government and agency securities and other short-term instruments, which are stated at fair value.

G. Deposits and Investments

Deposits

Deposits are carried at cost and consist of cash in bank and cash in State Treasury totaling \$242,260 and \$415,625, respectively. State Treasury Management Law governs the management of funds held in the State Treasury, and the Treasurer of State is responsible for ensuring these funds are adequately insured and collateralized.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

G. Deposits and Investments (continued)

Custodial Credit Risk – Custodial credit risk for deposits is the risk that, in the event of the failure of a depository institution, the System will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The System has adopted the State Board of Finance Policy requiring the use of depository insurance and collateralization procedures to manage the risk that deposits may not be returned. As of June 30, 2018, none of the bank balance of \$242,260 was exposed to custodial credit risk.

Investments

Ark. Code Ann. §§ 24-2-601 – 24-2-619 grants the ASHERS Board of Trustees full power to invest and reinvest monies of the System and to hold, purchase, sell, assign, transfer, or dispose of any of the investments or proceeds of the investments in accordance with the prudent investor rule. The Code also states the System shall seek to invest no less than 5% or more than 10% of its portfolio in Arkansas-related investments, as long as the System's responsibility to invest in accordance with the prudent investor rule is not limited or impaired. Some specific investment guidelines established by the Board of Trustees are as follows:

- Equities – No more than 5% of the System's total assets may be invested in the equities of any one company or affiliated group of companies.
- Fixed Income – No more than 3% of the System's total assets may be invested in any one-debt issue. Also, no more than 5% of the System's total assets may be invested in the debt securities of any one issuer. None of the above limitations on issues and issuers shall apply to United States Treasury or government guaranteed or agency debt securities. Debt securities purchased shall carry an investment rating of BAA or better by Moody's or a rating of BBB or better by Standard & Poor's.
- Asset Allocation – No more than 75%, with a 5% tolerance, of the System's portfolio may be invested in equities, and no more than 75%, with a 5% tolerance, may be invested in fixed income.
- Stock Index Derivatives – These may be utilized for the purpose of hedging risk and adjusting asset allocation. The Board authorizes the use of Stock Index Derivatives and exchange traded funds that trade on U.S. exchanges.
- Cash Equivalents – Short-term funds may be invested in direct U.S. Government Obligations, such as U.S. Treasury Bills, and Repurchases Agreements which are fully collateralized by U.S. Treasury issues or commercial paper with a rating of A1+P1.

The Agency categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation assumptions used to measure the fair value of the asset as follows:

- Level 1 – quoted prices in active markets for identical assets.
- Level 2 – significant other observable assumptions.
- Level 3 – significant unobservable assumptions.

Assets classified in Level 1 are valued directly from a predetermined primary external pricing vendor. Assets classified in Level 2 are subject to pricing by an alternative pricing source due to lack of information available by the primary vendor. Assets classified in Level 3 are valued using an internal fair value as provided by the investment manager due to lack of an independent pricing source. Investments that are valued using the net asset value per share (or its equivalent) as a practical expedient are not classified in the fair value hierarchy.

The fair value measurement of plan investments and securities lending collateral as of June 30, 2018, was as follows:

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

G. Deposits and Investments (continued)

Plan Investments Measured at Fair Value	Total	Level 1	Level 2	Level 3
U.S. Government obligations	\$ 50,800,131		\$ 50,800,131	
Government agency securities	4,352,561		4,352,561	
Domestic equities:				
Common stock	779,081,523	\$ 779,081,523		
American depository receipts	29,435,683	29,435,683		
International equities:				
Global equity	95,185,670	95,185,670		
Global preferred stock	1,342,266	1,342,266		
Global depository receipt	1,207,384	1,207,384		
Corporate obligations	162,490,083		162,490,083	
Mortgage-backed securities	3,179,033		3,179,033	
Fixed income exchange traded funds	50,392,896	50,392,896		
Municipal bonds	11,900,257		11,900,257	
Mutual and exchange traded funds	41,531,250	41,531,250		
Master limited partnerships	72,240,472	72,240,472		
 Total Plan Investments Measured at Fair Value	 <u>\$ 1,303,139,209</u>	 <u>\$ 1,070,417,144</u>	 <u>\$ 232,722,065</u>	 <u>\$ 0</u>
 Short-term investments	 <u>\$ 169,273,147</u>	 <u>\$ 169,273,147</u>	 <u>\$ 0</u>	 <u>\$ 0</u>
 Securities Lending Collateral:				
NILAP short-term investment pool*	<u>\$ 44,216,330</u>			

*Cash collateral received totaled \$44,214,887. The amount reported in the GASB 40 footnote above is the market value of the collateral received at June 30, 2018.

Cash equivalents invested in short-term investment funds are valued at amortized cost, which approximates fair value. The fund may issue and redeem shares at any time.

Securities Lending Collateral – Cash collateral received from borrowers in the securities lending program are invested in a short-term investment pool, the NILAP fund, which operates as a “government money market fund.” The value of this fund has been determined by the fund administrator.

Rate of Return – The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested. For the year ended June 30, 2018, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 15.64%.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Investments can be highly sensitive to changes in interest rates due to their terms or characteristics. A formal investment policy has not been adopted by the Board of Trustees that limits investment maturities as a means of managing the System’s exposure to fair value losses arising from increasing interest rates. The following summary indicates that 50.74% of investment maturities are one year or longer.

As of June 30, 2018, the System has the following investment balances and segmented maturities:

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

G. Deposits and Investments (continued)

Investment Type	Fair Value	Investment Maturities (In Years)			
		Less than 1	1-5	6-10	More than 10
Short-term investments	\$ 169,273,147	\$ 169,273,147			
U.S. Government obligations	50,800,131	2,949,326	\$ 32,487,893	\$ 9,962,677	\$ 5,400,235
Government agency securities	4,352,561	991,300	2,804,789	556,472	
Domestic corporate bonds	162,490,083	48,266,030	54,341,799	59,474,754	407,500
Municipal bonds	11,900,257	1,382,551	5,193,306	4,072,500	1,251,900
Fixed income exchange traded funds	50,392,896		3,007,300		47,385,596
Mortgage-backed securities	3,179,033		337,110	340,903	2,501,020
Total	\$ 452,388,108	\$ 222,862,354	\$ 98,172,197	\$ 74,407,306	\$ 56,946,251
Securities Lending Collateral					
NILAP short-term investment pool	\$ 44,216,330	\$ 44,216,330			

Corporate Bonds – As of June 30, 2018, corporate bonds and fixed income exchange traded funds had a fair value of \$212,882,979. Corporate bonds are debt instruments that are issued by private corporations. They have a term maturity and can have either a fixed or variable interest rate. Variable interest rate bonds have adjustments that are made periodically and vary directly with movements in interest rates. At June 30, 2018, the corporate bonds held by the System were considered sensitive to changes in interest rates.

Credit Risk – Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. This risk is measured by the credit quality of investments in debt securities as described by nationally-recognized statistical rating organizations. The Board of Trustees has adopted a formal investment policy for credit risk as described in the investment guidelines outlined above. The System's exposure to credit risk as of June 30, 2018, was as follows:

Standard and Poor's		Moody's Investors Service	
Rating	Fair Value	Rating	Fair Value
AAA	-	Aaa	\$ 55,152,692
AA	\$ 33,718,326	Aa	11,403,841
A	69,763,196	A	82,868,209
BBB	75,027,408	Baa	67,528,244
BB	2,340,000	Ba	5,819,373
B	-	B	-
Not Rated	102,266,031	Not Rated	60,342,602
Total	\$ 283,114,961	Total	\$ 283,114,961

Custodial Credit Risk – Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the System, and are held by either the counterparty or the counterparty's trust department or agent but not in the System's name. A formal investment policy for custodial credit risk has not been adopted by the Board of Trustees. As of June 30, 2018, no investments were exposed to custodial credit risk.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

G. Deposits and Investments (continued)

Concentration of Credit Risk – Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer (not including investments issued or explicitly guaranteed by the U.S. Government, investments in mutual funds, or external investment pools). The Board of Trustees has adopted a formal investment policy for concentration of credit risk as described in the investment guidelines outlined above. As of June 30, 2018, no investments in any one issuer or company represented more than 5% of the System's total investments, and no investments in any one debt issue represented more than 3% of the System's total investments.

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit. A formal investment policy for foreign currency risk has not been adopted by the Board of Trustees. As of June 30, 2018, exposure to foreign currency risk for investments was as follows:

Currency		Equities
Australian Dollar	AUD	\$ 4,167,084
British Pound	GBP	22,545,419
Canadian Dollar	CAD	5,089,278
Danish Krone	DKK	2,780,620
Euro	EUR	26,173,104
Hong Kong Dollar	HKD	1,390,374
Indonesian Rupiah	IDR	575,887
Japanese Yen	JPY	25,188,475
Malaysian Ringgit	MYR	682,449
Norwegian Krone	NOK	555,861
Philippine Peso	PHP	522,089
Singapore Dollar	SGD	481,056
South African Rand	ZAR	895,008
South Korean Won	KRW	616,163
Swedish Krona	SEK	2,746,604
Swiss Franc	CHF	1,597,350
Thailand Baht	THB	534,666
Total Exposure		<u>\$ 96,541,487</u>

Depository Receipts – A depository receipt is a negotiable certificate issued by a bank to represent a foreign company's publicly traded securities. A custodian bank in the foreign country holds the actual shares, often in the form of an American depository receipt (ADR), which is listed and traded on exchanges based in the United States, or a global depository receipt (GDR), which is traded in established non-U.S. markets. Indirectly, depository receipts are exposed to foreign currency risk since the non-U.S. company would be doing business in a foreign currency. At June 30, 2018, the System had \$29,435,683 invested in ADRs and \$1,207,384 invested in GDRs.

Concentrations of Investments – Generally accepted accounting principles require each pension plan to disclose investments (other than those issued or guaranteed by the U.S. Government) in any one organization that represent 5% or more of the fiduciary net position. As of June 30, 2018, no investments in any one organizations made by the System represented 5% or more of the fiduciary net position.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

G. Deposits and Investments (continued)

Securities Lending Transactions – The ASHERS Board of Trustees' policies permit ASHERS to enter into securities lending transactions, whereby securities are lent to broker-dealers or other entities for collateral with simultaneous agreement to return the collateral for the same securities in the future. ASHERS' securities lending program is administered by The Northern Trust Company (the "Custodian"). The legal and contractual authorization for the securities lending program is contained in the Securities Lending Authorization Agreement between ASHERS and the Custodian. There were no restrictions on the amount of security loans that can be made, and for the year ended June 30, 2018, there were no known violations of the Authorization Agreement. Securities are loaned versus collateral that may include cash, U.S. government securities, and irrevocable letters of credit. U.S. securities are loaned versus collateral valued at 102% of the market value of the securities plus any accrued interest. Non-U.S. securities are loaned versus collateral valued at 105% of the market value of the securities plus any accrued interest. Cash open collateral is invested in a short-term investment pool, the NILAP fund, which operates as a "government money market fund." At year-end, there was no credit risk exposure to borrowers because the value of collateral is greater than the value of the assets on loan. The Custodian provides for indemnification for any losses that might occur due to the insolvency of a borrower and the Custodian failing to live up to its contractual responsibilities relating to the lending of those securities. The Custodian's responsibilities include performing appropriate borrower and collateral investment credit analysis, demanding adequate types and levels of collateral, and complying with applicable Department of Labor and Federal Financial Institutions Examination Council regulations concerning securities lending. Collateral securities received cannot be pledged or sold unless the borrower defaults. Cash collateral received is invested and appears as an asset on the Statement of Fiduciary Net Position. A corresponding liability is recorded, as the cash collateral must be returned to the borrower upon expiration of the loan. All securities loans can be terminated on demand by either the lender or the borrower, although the average term of ASHERS loans was approximately 61 days as of June 30, 2018.

H. Contributions and Reserves

Contributions – The general financial objective of all Arkansas public employee retirement plans is to have rates of contribution that remain relatively level for Arkansas citizens from generation to generation. The employer contribution rate is established under state statute and is not based on a funding policy. The statutory employer contribution rate was 12.9% for the fiscal year ending June 30, 2018. To determine the adequacy of the employer contribution rate and analyze the financial condition, the System has actuarial valuations prepared annually. Contributory members are required by Act 295 of 1981 to contribute 6% of gross wages to the System. Any employee contributions are refundable if covered employment terminates before a monthly benefit is payable. Employee contributions remaining on deposit with ASHERS for a period of one or more years earn interest credits, which are included in the refund.

Since the State statutes governing the System establish the current employee and State contribution rates, the actuarial valuation determines the number of years required to amortize, or fund, the unfunded actuarial accrued liability (UAAL) on a level percentage of payroll basis, taking into account the payroll growth assumption and the normal cost expressed as a percent of pay. As of June 30, 2018, the System's UAAL is \$281.2 million, and the current funding period has increased to infinite. The total contribution rate would need to be about 23.3% (compared to the current 18.9%) to meet the 30-year payoff of the UAAL. Because the employer contribution rate is established under state statute and is not based on funding policy, no actuarially determined contribution is disclosed in the schedule of contributions (Schedule 2).

Reserves – Arkansas Code does not require specific reserves for the System. Ark. Code Ann. § 24-5-108 expressly guarantees that all member contributions be held in trust for the exclusive benefit of the individual contributor. As of June 30, 2018, member contributions held in reserves totaled \$71,633,068.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 1: Summary of Significant Accounting Policies (continued)

I. Deferred Outflows of Resources and Deferred Inflows of Resources

Deferred outflows of resources represent a decrease of net position that applies to future periods. Thus, these items will not be recognized as an outflow of resources (an expense or expenditure) until a future period.

Deferred inflows of resources represent an increase of net position that applies to future periods. These items will not be recognized as an inflow of resources (revenue) until a future period.

NOTE 2: Deferred Retirement Option Plan (DROP)

Ark. Code Ann. §§ 24-5-201 – 24-5-204 authorizes the ASHERS Board of Trustees to establish a deferred retirement option plan for its members so that, in lieu of terminating employment, they might continue with employment and accept a service retirement benefit pursuant to Ark. Code Ann. § 24-5-101. The Board shall be authorized to promulgate rules and regulations for a plan to provide this deferred retirement option to its members as is appropriate to maintain a goal of zero cost to the System.

The Board has established participation eligibility requirements for the DROP to be the earliest of the following:

- 1) Completion of 30 years of creditable service.
- 2) Age 60 and 20 years of creditable service.
- 3) Age 62 and 15 years of creditable service.
- 4) Age 65 and 5 years of creditable service.

A member's election to enter the DROP is irrevocable, and additional service credit cannot be accumulated. A member can remain in DROP to the later of age 65 or the completion of five years of participation in DROP, at which time employment must terminate. DROP is divided into Tier I and Tier II. Tier I consists of the first five years of participation in DROP, while Tier II is the remaining period. In Tier I, 90% of a member's retirement annuity is deposited into the member's DROP account, whereas in Tier II, the amount deposited is reduced to 79% of the member's retirement annuity. During DROP, the member will receive the regular cost of living adjustments to their service retirement. DROP accounts are credited with interest set at a rate determined by the Board of Trustees. Currently, the interest rate is set at 6%.

Member and employer contributions cease during an employee's participation in DROP Tier I; however, when an employee enters Tier II, the member starts to contribute 6% of total payroll earnings again, and the employer contributes 6.9%. When the DROP participant terminates employment and actually retires, the member will receive the DROP balance and commence receiving the full regular annuity payments.

Members have the option to receive distribution of the DROP account balances when employment terminates or can leave the DROP account balance with the System, in which case the member will continue to receive interest on the account balance. DROP distributions can be made by members monthly by completing a withdrawal request form. Distributions from a member's DROP account can be as a lump-sum or rolled over into a tax deferred account.

At June 30, 2018, DROP balances held by the System for both active members and retirees totaled \$46,218,201 and \$177,579,332, respectively.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2018

NOTE 3: Net Pension Liability

The components of the net pension liability at June 30, 2018, were as follows:

Total pension liability	\$1,991,358,627
Less: plan net position	<u>1,472,472,865</u>
Net pension liability	<u>\$ 518,885,762</u>

Plan net position as a percentage of the total pension liability	73.94%
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Actuarial Assumptions – The total pension liability was determined by an actuarial valuation as of June 30, 2018, using the following actuarial assumptions that incorporates the new assumptions adopted by the Board effective with the June 30, 2017, actuarial valuation.

Wage inflation rate	2.50%
Salary increases	3.50% - 10.50%
Investment rate of return	8.00%

Mortality rates were based on the RP-2000 Combined Healthy mortality table with Blue Collar adjustments for males and females, scaled with no setback. Generational mortality improvements are in accordance with Scale AA from the table's base year of 2000.

Discount Rate – A single discount rate of 6.62% was used to measure the total pension liability as of June 30, 2018. The single discount rate was based on the expected rate of return on pension plan investments of 8% and the municipal bond rate of 3.62%. The projection of cash flows, based on the assumptions made, found that the pension plan's net position was not projected to make all projected future benefit payments of current plan members. Therefore, the single discount rate of 6.62% was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the Net Pension Liability – Regarding the sensitivity of the net pension liability to changes in the single discount rate, the following presents the net pension liability, calculated using the current discount rate, as well as what the net pension liability would be if it were calculated using a single discount rate that is 1% lower and 1% higher than the current rate:

<u>Sensitivity of the Net Pension Liability to</u>			
<u>Changes in the Discount Rate</u>			
	1% Decrease	Current Rate	1% Increase
	5.62%	6.62%	7.62%
Net pension liability	<u>\$ 780,324,234</u>	<u>\$518,885,762</u>	<u>\$ 309,720,055</u>

NOTE 4: Required Supplementary Schedules

Detailed historical information about the pension liabilities for which the pension plan's assets are being held and managed and the significant assumptions used to measure these liabilities are required supplementary information. This required supplementary information, prepared in accordance with the parameters of GASB Statement No. 67, is included immediately following the notes to the financial statements.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
SCHEDULE OF CHANGES IN NET PENSION LIABILITY AND RELATED RATIOS
FOR THE TEN-YEAR PERIOD ENDED JUNE 30, 2018

Schedule 1

	2018	2017	2016	2015	2014	2013 to 2009*
TOTAL PENSION LIABILITY						
Service cost	\$ 23,601,075	\$ 42,816,372	\$ 18,935,319	\$ 18,412,588	\$ 16,862,918	
Interest	113,808,845	110,543,661	126,829,266	115,441,556	112,962,064	
Benefit changes		(101,042,380)				
Difference between actual and expected experience	49,165,072	(31,506,816)	20,925,790	20,790,869		
Assumption changes	(331,139,733)	(137,435,476)	790,989,712	91,940,822		
Benefit payments	(115,747,730)	(111,904,597)	(106,755,840)	(102,245,806)	(95,454,598)	
NET CHANGE IN TOTAL PENSION LIABILITY	(260,312,471)	(228,529,236)	850,924,247	144,340,029	34,370,384	
TOTAL PENSION LIABILITY - BEGINNING OF YEAR	2,251,671,098	2,480,200,334	1,629,276,087	1,484,936,058	1,450,565,674	
TOTAL PENSION LIABILITY - END OF YEAR	\$ 1,991,358,627	\$ 2,251,671,098	\$ 2,480,200,334	\$ 1,629,276,087	\$ 1,484,936,058	
PLAN FIDUCIARY NET POSITION						
Contributions - employer	\$ 19,294,283	\$ 19,175,401	\$ 19,231,804	\$ 19,059,012	\$ 18,614,507	
Contributions - member	9,163,176	9,143,408	9,379,784	9,138,451	8,884,829	
Net investment income	205,497,639	133,167,344	(60,344,122)	25,383,756	234,208,606	
Benefit payments	(115,747,730)	(111,904,597)	(106,755,840)	(102,245,806)	(95,454,598)	
Administrative expense	(55,703)	(130,076)	(118,199)	(91,542)	(43,282)	
Other						
NET CHANGE IN PLAN NET POSITION	118,151,665	49,451,480	(138,606,573)	(48,756,129)	166,210,062	
PLAN NET POSITION - BEGINNING OF YEAR	1,354,321,200	1,304,869,720	1,443,476,293	1,492,232,422	1,326,022,360	
PLAN NET POSITION - END OF YEAR	\$ 1,472,472,865	\$ 1,354,321,200	\$ 1,304,869,720	\$ 1,443,476,293	\$ 1,492,232,422	
Plan net position as a percentage of total pension liability	73.94%	60.15%	52.61%	88.60%	100.49%	
Covered employee payroll	\$ 148,527,851	\$ 141,154,763	\$ 141,906,487	\$ 140,544,393	\$ 137,261,720	
Net pension liability as a percentage of covered employee payroll	349.35%	635.72%	828.24%	132.20%	(5.32)%	

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
 SCHEDULE OF CONTRIBUTIONS
 FOR THE TEN-YEAR PERIOD ENDED JUNE 30, 2018

Schedule 2

	2018	2017	2016	2015	2014	2013 to 2009*
Actuarially determined contribution	N/A	N/A	N/A	N/A	N/A	
Actual contribution	\$ 19,294,283	\$ 19,175,401	\$ 19,231,804	\$ 19,059,012	\$ 18,614,507	
Contribution deficiency (excess)	N/A	N/A	N/A	N/A	N/A	
Covered payroll	\$ 148,527,851	\$ 141,154,763	\$ 141,906,487	\$ 140,544,393	\$ 137,261,720	
Actual contribution as a percentage of covered employee payroll	12.99%	13.58%	13.55%	13.56%	13.56%	

* ASHERS is only required to present those years for which information is available until the full 10-year trend is completed.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
SCHEDULE OF INVESTMENT RETURNS
FOR THE TEN-YEAR PERIOD ENDED JUNE 30, 2018

Schedule 3

	<u>Annual money- weighted rate of return</u>
2013 to 2009*	
2014	18.08%
2015	1.74%
2016	-4.29%
2017	10.51%
2018	15.64%

* ASHERS is only required to present those years for which information is available until the full 10-year trend is completed.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
 NOTES TO REQUIRED SUPPLEMENTARY INFORMATION
 JUNE 30, 2018

NOTE 1: Summary of Significant Information Related to Required Supplementary Schedules

- A. Changes in benefit terms – There were no significant benefit changes for the year ended June 30, 2018.
- B. Changes in assumptions – The single discount rate increased from 5.16% at the beginning of the year to 6.62% at the end of the fiscal year. This change in the single discount rate decreased the net pension liability by \$331 million and is included in the Schedule of Changes in the Employers' Net Pension Liability (Schedule 1) as an assumption change.
- C. Covered payroll – The prior three schedules of RSI include covered payroll as a data point. Paragraph five of GASB 82 clarified this definition by adding the following: Covered payroll is the payroll on which contributions to a pension plan are based. Beginning with the 2018 disclosures that amount is disclosed to the extent the data allows. The amounts for previous years in the schedule have not been adjusted.
- D. Notes to Schedule of Contributions

The following actuarial methods and assumptions were used in the yearly valuation for the year ended June 30, 2018:

Cost method	Entry age normal
Amortization method	Level percentage of salary
Remaining amortization	30 years
Asset valuation method	4-year smoothed market value
Investment rate of return	8.0%
Inflation	2.5%
Salary scale	3.5% to 10.5%, total payroll growth of 3.0%
Mortality	RP-2000 Combined Healthy Lives with Blue Collar adjustment scaled at 105%, Projected with scale AA.
	RP-2000 Combined Healthy Lives with Blue Collar adjustment scaled at 100%, Projected with scale AA.

NOTE 2: Differences between Exhibits and Required Supplementary Information

Schedule 1 – The Schedule of Changes in Net Pension Liability and Related Ratios does not include changes to the financial data made subsequent to year-end. The total assets and total liabilities were updated subsequent to the release of the actuary report. Information presented in this schedule may not agree with Exhibit A or Exhibit B.

ARKANSAS STATE HIGHWAY EMPLOYEES RETIREMENT SYSTEM
SCHEDULE OF SELECTED INFORMATION
FOR THE FIVE-YEAR PERIOD ENDED JUNE 30, 2018
(Unaudited)

Schedule 4

	For the Year Ended June 30,				
	2018	2017	2016	2015	2014
Total Assets	\$ 1,525,314,156	\$ 1,380,622,900	\$ 1,309,099,249	\$ 1,444,616,838	\$ 1,492,267,635
Total Liabilities	52,795,422	26,273,905	4,155,080	1,117,295	15,020
Total Deferred Inflows of Resources	44,427	27,795	8,955	23,250	19,894
Net Pension Restricted for Pension Benefits	1,472,474,308	1,354,321,200	1,304,935,214	1,443,476,293	1,492,232,721
Total Additions	233,956,541	161,420,658	(31,667,040)	53,580,920	261,698,165
Total Deductions	115,803,433	112,034,673	106,874,039	102,337,348	95,497,880