

MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

(A Component Unit of the County of Mendocino)

FINANCIAL STATEMENTS
WITH ACCOMPANYING INFORMATION

YEAR ENDED JUNE 30, 2010

WITH

REPORT OF CERTIFIED PUBLIC ACCOUNTANT

V. James Sligh
Certified Public Accountant
413 W. Standley St., Suite A
Ukiah, CA 95482

MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

YEAR ENDED JUNE 30, 2010
TABLE OF CONTENTS

Board of Retirement	1
Independent Auditor's Report	2-3
Management's Discussion and Analysis - Required Supplementary Information	4-8
Financial Statements:	
Statement of Plan Net Assets as of June 30, 2010	9
Statement of Changes in Plan Net Assets for the Year Ended June 30, 2010	10
Notes to Financial Statements	11-22
Required Supplementary Information (Unaudited):	
Schedule of Funding Progress	23
Schedule of Employer Contributions	23

Board of Retirement

County Treasurer

Shari Schapmire

Appointed by the Mendocino County Board of Supervisors

Dr. Donald Coursey

Bob Mirata, Vice-Chairperson

Caren Callahan

Kendall Smith

Elected Members

Randy Goodman, Director

Dennis Huey, Secretary

Timothy Pearce, Chairperson

Lloyd Weer, Director

Timothy J. Knudsen, Retiree Alternate

Administration

Jim Andersen - Retirement Administrator

Sue Thornhill - Retirement Division Coordinator

V. James Sligh

Certified Public Accountant

413 West Standley St., Suite A
Ukiah, CA 95482
Tel. & Fax (707) 462-8635
E-Mail slick@pacific.net

Board of Retirement
Mendocino County Employees' Retirement Association
Ukiah, California

INDEPENDENT AUDITOR'S REPORT

I have audited the accompanying statement of plan net assets of the Mendocino County Employees' Retirement Association (Association), a component unit of the County of Mendocino, as of June 30, 2010, and the related statement of changes in plan net assets for the year then ended, as listed in the table of contents. These financial statements are the responsibility of the Association's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my 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 I 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. I believe that my audit provides a reasonable basis for my opinion.

In my opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Mendocino County Employees' Retirement Association as of June 30, 2010, and the changes in plan net assets for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, I have also issued my report dated January 25, 2011, on my consideration of the Association's internal control over financial reporting and my 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 my 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 my audit.

The Management's Discussion and Analysis on pages 4 through 8, and other required supplementary information listed in the table of contents are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United

States of America. I have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, I did not audit the information and express no opinion on it.



V. James Sligh, CPA
Ukiah, California
January 25, 2011

Management's Discussion and Analysis

The following section provides an overview and analysis of the Mendocino County Employees' Retirement Association (MCERA) financial activities for the year ended June 30, 2010. We encourage readers to take into account the information presented here in conjunction with additional information we have furnished in the financial statements.

FINANCIAL HIGHLIGHTS

MCERA net assets as of June 30, 2010 are \$300 million. This amount reflects an increase of 10.3% in net assets during Fiscal Year 2009-2010.

MCERA's funding objective is to meet the long-term benefit obligations through contributions and investment income. As of June 30, 2010, the date of our last actuarial valuation, the funding ratio was 78.94%. In general, this indicates that for every dollar of benefits owed we had approximately \$.79 of assets available for payment as of that date. In June of 2010, the MCERA Board changed its interest posting and excess earnings policy to direct all future excess earnings toward unfunded accrued actuarial liability (UAAL), with the intent of improving the funded status of the plan.

Revenues (additions to plan assets) for the year were \$52.9 million. This was comprised of \$8.2 million of employer contributions, \$6.5 million of member contributions and an investment return of \$38.1 million.

Expenses (deductions in plan assets) for the year were \$ 24.9 million, an increase of \$2.1 million, or 9.2 %, over the prior year. The increase in expenses primarily came from pension benefits. After the conclusion of the 2009-10 fiscal year, the legislature passed Assembly Bill 609, which was signed into law by the Governor, providing for a more stable funding source for retirement system administrative expenses. AB 609 provided funding of 21/100ths of 1% of the accrued actuarial liabilities (AAL), or \$2 million, whichever is greater, for administrative expenses.

OVERVIEW OF FINANCIAL STATEMENTS

The following discussion and analysis are intended to serve as an introduction to MCERA's financial statements, which are comprised of the following components:

- Statement of Plan Net Assets (page 9)
- Statement of Changes in Plan Net Assets (page 10)
- Notes to the Financial Statements (page 11)

The Statement of Plan Net Assets is a snapshot of account balances at year-end. It indicates the assets available for future payments to retirees and any current liabilities owed.

The Statement of Changes in Plan Net Assets provides a view of the current year additions to and deductions from the plan. This statement covers the activity over a one-year period of time.

Both statements are in compliance with Government Accounting Standards Board (GASB) Statements No. 25, 28, 33, 34, 37, 38, 50, and 56. These pronouncements require certain

disclosures and require the state and local governments report using the full accrual method of accounting. MCERA complies with all material aspects of the pronouncements.

The Statement of Plan Net Assets and Statement of Changes in Plan Net Assets report information about MCERA activities. These statements include all assets and liabilities, using the full accrual basis of accounting which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when the cash is received or paid. All investment gains and losses are shown at trade date, not settlement date. In addition, both realized and unrealized gains and losses are shown on investments. All capital assets are depreciated over their useful lives.

Over time, increases and decreases in MCERA's net assets are one indicator of whether its financial health is improving or deteriorating. Other factors, such as recent market conditions, should also be considered in measuring MCERA's overall financial health.

Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the financial statements. Please note that this report also contains other supplemental information in addition to the basic financial statements themselves.

MCERA NET ASSETS

Dollars in Thousands	06/30/2010	06/30/2009	Increase/ (Decrease)	% Change
Cash and Short Term Investments	16,192	16,021	171	1.1%
Receivables	2,016	1,843	173	9.4%
Investments, at fair value	283,670	254,779	28,891	11.3%
Total Assets	301,878	272,643	29,235	10.7%
Accounts Payable	293	83	210	253.0%
Accrued Expenses	22	24	(2)	-8.3%
Investment Purchases	1,520	495	1,025	207.1%
Total Liabilities	1,835	602	1,233	204.8%
Net Assets Held in Trust for Benefits	300,043	272,041	28,002	10.3%

The Retirement Fund as a Whole

MCERA's net assets increased 10.3 % in 2010 reflecting investment returns of 14.47 %. Investment returns can vary significantly from year to year. MCERA maintains a diversified investment portfolio and asset allocation that is structured to meet the long term funding requirements of the plan. Five year investment returns, net of fees, are 3.99%. A long-term investment strategy incorporating structured diversification and a balanced investment portfolio are critical to meeting return targets over time. MCERA management and its actuary concur that MCERA remains in a financial position that will enable the plan to meet its obligations to participants and beneficiaries. MCERA and its investment consultants conducted a liability and asset allocation study in June of 2010, and the MCERA Board adopted new investment targets that the Board believes will result in MCERA coming closer to meeting its actuarial assumed rate of return (8%) while taking on little increased risk. The Board, upon advice of the investment consultants, strived to create a portfolio that takes advantage of the returns of stocks, especially international stocks. The portfolio also better balances large capitalized investments with smaller capitalized investments, and provides a balance of value and growth investment philosophies.

The MCERA Board is also currently reviewing its fund managers, which have performed well during the market downturn and recovery. Fund managers contributed 2.82% above investment benchmarks for the one year period ending June 30, 2010.

Investment Analysis

As stated above, investment returns increased in 2010 with a 14.47 % return at the total portfolio level. During the period of 2008 through March of 2009, there was a decline in worldwide markets greater than any since the Great Depression. This market decline drove the five year annualized portfolio return down to 3.99%, net of fees. MCERA's asset allocation during 2010 included 39% U.S. equities, 20% international equities, 31% fixed income and 10% real estate. As noted above, the MCERA Board conducted a study and amended its asset allocation slightly reducing investments in fixed income and real estate, and increasing its investments in international equities. MCERA's total portfolio returns were 14.47%, -2.76% and 3.33% for the one, three and five year periods ended June 30, 2010, respectively.

MCERA RESERVES

Dollars in Thousands	6/30/10	6/30/09	6/30/08
Member Reserve	63,975	64,102	62,348
Employer Reserve	(15,618)	(2,559)	3,459
Annuitant Reserve	167,440	155,083	150,148
Cost of Living Reserve	82,667	83,221	83,594
Retiree Health Care Benefit Reserve	2,449	6,345	9,994
Contingency Reserve	3,000	2,720	3,313
Miscellaneous Reserves	3	7	4
Total	303,916	308,919	312,860

Reserves

MCERA's reserves are established from contributions and the accumulation of investment income after satisfying investment and administrative expenses. Under GASB 25, investments are stated at fair value instead of cost and include the recognition of unrealized gains and losses in the current period. MCERA has adopted a five-year smoothing methodology for investment gains and losses. This has the effect of smoothing both positive and negative fluctuations in investment performance versus assumptions and has a stabilizing effect on contribution rates. In May of 2010, the MCERA Board directed its staff to conduct a procurement process for an actuarial audit. The audit would test both the accuracy of work conducted by our primary actuary and the assumptions used by the actuary. The results of the audit are expected in February of 2011.

CHANGES IN MCERA NET ASSETS

Dollars in Thousands	06/30/10	06/30/09	Increase/ (Decrease)	% Change
Additions				
Employer Contributions	8,234	8,561	(327)	-3.8%
Member Contributions	6,502	6,836	(334)	-4.9%
Employer Reimbursement	4	322	(318)	-98.8%
Net Investment Income	38,128	(52,214)	90,342	-173.0%
Total Additions	52,868	(36,495)	89,363	-244.9%
Deductions				
Retirement Benefits	23,161	21,480	1,681	7.8%
Refund of Contributions	1,061	734	327	44.6%
Administrative Expenses	645	602	43	7.1%
Total Deductions	24,867	22,816	2,051	9.0%
Change in Net Assets	28,001	(59,311)	87,312	-147.2%

Revenues (Additions to Plan Assets)

The primary sources to finance the benefits MCERA provides to its members are accumulated through income on investments and through the collection of employee and employer contributions. These income sources for the fiscal year ended June 30, 2010 totaled \$52.9 million. The increase in revenues can be attributed primarily to investment income. The increase in investment income is a result of the emerging recovery from the world-wide market decline described above. The total balance of investment assets increased from approximately \$272 million in 2009 to \$301 million in 2010. Subsequent to June 30, 2010, asset values have continued to recover and were approximately \$340 million as of December 31, 2010.

Expenses (Deductions in Plan Assets)

The primary uses of MCERA assets are the payment of benefits to retirees and their beneficiaries, refunds of contributions to terminated employees, and the cost of administering the system. These expenses for the fiscal year ended June 30, 2010 were \$644 thousand, an increase of \$43 thousand

compared to the year ended June 30, 2009. Pension benefits increased \$1.6 million almost exclusively due to an increase in the number of retirees. As discussed above, AB 609 increased the amount of investment returns that could be used for administrative expenses. The MCERA Board will be reviewing staffing levels and information technology needs during the upcoming year.

Fiduciary Responsibility

MCERA's Board and staff are fiduciaries of the pension fund. Under the California Constitution the assets can only be used for the benefit of plan participants and their beneficiaries.

Request for Information

The financial report is designed to provide the Retirement Board, our membership, tax-payers, investment managers and creditors with a general overview of MCERA finances and to account for the money it receives. Questions concerning any of the information in this report or requests for additional financial information should be addressed to:

MCERA
625 B Kings Court
Ukiah, CA 95482

Respectfully submitted,

James Andersen
Retirement Administrator

Mendocino County Employees' Retirement Association

(A Component Unit of the County of Mendocino)

Statement of Plan Net Assets

June 30, 2010

ASSETS

Cash and cash equivalents	<u>\$16,191,776</u>
Receivables	
Employers	46,281
Investment sales	814,942
Interest and dividends receivable	1,002,293
Other receivables	152,918
Total receivables	<u>2,016,434</u>
Investments, at fair value	
U.S Government obligations	51,969,718
International bonds	7,080,383
Domestic corporate bonds	44,148,272
Domestic stocks	104,627,860
International stocks	52,327,297
Real estate	23,516,305
Total investments	<u>283,669,835</u>
Total assets	<u>301,878,045</u>

LIABILITIES

Accounts payable	293,357
Accrued expenses	22,063
Investment purchases	1,520,063
Total liabilities	<u>1,835,483</u>

Net assets held in trust for pension benefits (A schedule of funding progress is presented on page 23)	<u>\$300,042,562</u>
--	----------------------

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

Mendocino County Employees' Retirement Association

(A Component Unit of the County of Mendocino)

Statement of Changes in Plan Net Assets

For the Year Ended June 30, 2010

<hr/>	
<hr/>	
Additions	
Contributions	
Employer	\$8,234,253
Plan members	6,502,080
Total contributions	<u>14,736,333</u>
Other income - reimbursement of administrative expenses	<u>4,057</u>
Investment income	
Net appreciation (depreciation) in fair value of investments	31,278,606
Rent income, net of expenses	92,159
Interest	5,054,338
Dividends	2,298,834
	<u>38,723,937</u>
Less investment expense	<u>595,494</u>
Net investment income (Loss)	<u>38,128,443</u>
Total additions	<u>52,868,833</u>
Deductions	
Benefit payments & subsidies	23,160,989
Refunds of contributions	1,061,327
Administrative expense	644,865
Total deductions	<u>24,867,181</u>
Net increase (decrease)	28,001,652
Net assets held in trust for pension benefits	
Beginning of year	<u>272,040,910</u>
End of year	<u>\$300,042,562</u>

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

MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2010

=====

DESCRIPTION OF PLAN

Description of Association and Applicable Provisions of the Law

The Mendocino County Employees' Asssocation (Association) is an integrated public retirement system established under and subject to the legislative authority of the State of California as enacted and amended the County Retirement Act of 1937 (Chapter 677 Statutes of 1937). It is a multiple-employer "Cost Sharing" defined benefit plan for the County of Mendocino, the Mendocino County Courts, and the Russian River Cemetery District. The Association was approved by the Board of Supervisors to become effective January 1, 1948, and was integrated with Social Security on January 1, 1956.

Membership in the plan at June 30, 2010 consisted of the following:

Retirees and beneficiaries receiving benefits	1,084
Terminated plan members entitled to but not yet receiving benefits	391
Active plan members	<u>1,274</u>
Total	<u>2,749</u>
Number of participating employers	<u>3</u>

A cost-sharing multiple employer plan is a single plan with pooling (cost-sharing) arrangements for the participating employers. All risks, rewards, and costs, including benefit costs, are shared and are not attributed individually to the employers. A single actuarial valuation covers all plan members. Other special districts within Mendocino County are eligible, but have not elected to participate.

All permanent employees who work at least 32 hours per week become members of the plan on the first day of the pay period following employment. Employees are classified as either general or safety (law enforcement) members, and are assigned to one of three tiers based on entry date and job classification.

Retirement benefits offered by the plan include normal retirement, disability retirement and service-connected disability retirement. A death benefit is available to beneficiaries. An annual cost of living adjustment of no more than 3 percent may be granted by the Board of Retirement. For 2010, the Board of Retirement approved cost of living increases ranging from 2.5% to 3%, depending on date of retirement, and became effective April 1, 2010.

Health benefits for retired employees have been funded by the plan in the past. As of September 1, 1998, the County of Mendocino has assumed responsibility for funding the cost of health care for the retired employees

DESCRIPTION OF PLAN (Continued)

of the County of Mendocino, and will be responsible for the cost of health care when Association earnings on investments are not in excess of required transfers of earnings to retirement reserve accounts. For eligibility for health care coverage, prior to September 1, 1998, retirees must have served 10 years prior to retirement with the County of Mendocino, and retire as an active member. The retiree health benefit program qualifies under section 401(h) of the Internal Revenue Code. Health care payments to reimburse the County for the cost of retiree health care are made from a special reserve that has been established as a result of prior excess earnings. This health care subsidy amounted to \$3,888,546 for the year ended June 30, 2010, and is included in the line item for benefit payments and subsidies on the Statement of Changes in Plan Net Assets. This subsidy is net of all health care payments by retirees.

Beginning January 1, 2009 and ending December 31, 2009, all retirees under the age of 65 were required to pay \$96.40 each month as a premium for health care paid by the Association, and \$595.44 for each covered dependent of a retiree. Beginning January 1, 2010 and ending July 31, 2010, all retirees under age 65 were required to pay \$171.40 each month, retirees over 65 were required to pay \$75 per month, and the dependent coverage increased to \$605.02 per month. As of August 1, 2010, and ending December 31, 2010, retirees under age 65 were required to pay \$531.20 per month, through the date of this report, with an increase for dependent coverage to \$731.20 per month. In addition, as of August 1, 2010 the County subsidizes the cost of premiums for both Medicare-eligible and other retirees, which is offset by accrued excess earnings of the Association. This subsidy for premiums is \$100 for retirees 65 and over beginning August 1, 2010, and those retirees are referred to Extend Health to purchase supplemental coverage. Retirees under 65 are given a supplement of \$200 per month beginning August 1, 2010 and ending December 31, 2010. The subsidy for each retiree in the under-65 group is \$288 per month beginning January 1, 2011. The premium for each dependent increased to \$819.20 per month beginning January 1, 2011. The reserve is adjusted to actual medical costs at the end of each fiscal year.

As of the date of this report, the balance in the health care reserve was approximately \$279,000. The health reserve, funded by excess earnings calculated as a result of actuarial valuations in prior years, will no longer be funded by excess earnings, as of June 16, 2010, until the accrued actuarial liability of the system is funded at 100 percent. In addition, excess earnings will be calculated using generally accepted accounting principles, not actuarial valuations.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Association is governed by the Board of Retirement and is considered an independent entity. The Association is a component unit of the County of Mendocino and is being reported as a Pension Trust Fund in the County's

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial Report in accordance with Governmental Accounting Standards Board Statement No. 14.

Basis of Accounting

The Association follows Governmental Accounting Standards Board (GASB) accounting principles and reporting guidelines, and financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to the plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Cash and Investments

Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Mortgage securities are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Investments that do not have an established market are reported at estimated fair value. All investments listed in the Statement of Plan Net Assets are registered securities held by the Association's agent in the Association's name. The Board of Retirement has exclusive control over all investments of the Association and is responsible for establishing investment objectives, strategies and policies.

The Board of Retirement has adopted an Investment Policy, which provides the framework for the management of the Association's investments. The Investment policy establishes the Association's investment objectives and defines the principal duties of the Board of Retirement and the investment managers. The asset allocation plan is an integral part of the Investment Policy and is designed to provide an optimum and diversified mix of asset classes with return expectations to satisfy expected liabilities while minimizing risk exposure. The Association currently employs investment managers to manage its assets subject to the provisions of the Investment Policy.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of cash in trust with the Treasurer of the County of Mendocino and cash held for investment by bond investment managers. Cash from deposits and cash needed for daily operational purposes is held in a pooled account with other County funds. The County Treasurer is responsible for the management, control, and safekeeping of all investments in the pooled fund. Interest on funds in the County investment pool is computed quarterly based on average daily balance. A deposit in the pooled account approximates fair value. Cash and cash equivalents are highly liquid investments with a short maturity and are recorded at cost, which approximates fair value.

Security transactions are accounted for on a trade date basis. Interest income is recognized when earned and dividend income is recognized on the ex-

CASH AND CASH EQUIVALENTS (Continued)

dividend date. Stock dividends or stock splits are recorded as memo items and do not affect the total value of the securities. Unrealized gains and losses on investments are reported as "net appreciation (depreciation) in the fair value of investments." The calculation of realized gains and losses is independent of the calculation of net appreciation (depreciation) in the fair value of plan investments. The Association's cash and investments stated at fair value as of June 30, 2010, are as follows:

Cash in Trust - Mendocino County	\$ 15,115,875
Cash in Trust - Bond Managers	1,075,884
Short-Term Investments - LAIF	<u>17</u>
Total Cash Equivalents	<u>16,191,776</u>
U.S. Government and Agency Bonds	51,969,718
International Bonds	7,080,383
Corporate Bonds	44,148,272
Domestic Stocks - Mutual Funds	101,646,920
Domestic Stocks - Commingled Fund (Alliance)	2,980,940
International Stocks - Mutual Funds	52,327,297
Real Estate	<u>23,516,305</u>
Total Investments	<u>283,669,835</u>
Total Cash Equivalents and Investments	<u>\$299,861,611</u>

In addition, at June 30, 2010, there are short-term investments of \$954,120 at the Bank of New York, and \$115,668 at Pimco Fund (a bond mutual fund) that are reported in the financial statements as interest, dividends, and investment sales receivable because these amounts represent current period earnings and securities sales that are to be immediately transferred to the Association. At June 30, 2010 the Association was owed \$814,942 by investment managers for sales of securities.

CUSTODIAL CREDIT RISK

Custodial credit risk for deposits is the risk that in the event of a failure in a depository financial institution, a government will not be able to recover its deposits or recover collateral securities that are in the possession of an outside party.

Custodial risk for deposits in the Mendocino County trust is assumed by the County of Mendocino. Short-term investments with the Bank of New York are not insured and are subject to risk of loss through market fluctuations, but risk of loss for fraudulent acts and lack of fidelity on the part of investment managers is covered by fidelity bonds for the Bank of New York investments. All the above short-term investments are stated at fair value. In accordance with GASB Statement No. 40 disclosure requirements, cash invested in external investment pools and in open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form.

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty, the government will not be able to recover the

CUSTODIAL CREDIT RISK (Continued)

value of its investment or collateral securities that are in the possession of an outside party. Except for a statement that duties of the Board of Retirement, Association officers and employees shall be discharged with care, skill, prudence, and diligence, the Association has no formal policy for managing custodial credit risk.

CREDIT RISK

Credit risk is the risk that an issuer or other counterparty to a debt instrument will not fulfill its obligations. This risk is measured by the assignment of ratings by nationally recognized statistical rating organizations. Investment allocation guidelines according to the investment policy is as follows:

	<u>Allowable Range</u>	<u>Target Percent</u>
U.S. Equity	33% - 43%	38%
Non-U.S. Equity	20% - 30%	25%
U.S. Fixed Income	23% - 33%	28%
Real Estate	4% - 14%	9%

The Association's Investment Policy does not allow for a single investment in real estate that is in excess of 5% of total assets. No single common stock investment, based on cost, shall exceed 2% of the assets of the Association, and may not exceed 5% of the shares outstanding. With respect to common stocks, the Association has a goal of diversifying the portfolio among a cross-section of industries that have sound long-term growth potential. Similar restrictions apply to fixed income securities. Single security restrictions do not apply to investments in mutual funds. For fixed income investments, corporate debt issues must be rated "A" or better by the Standard and Poor corporation (S&P). An exception to this policy is that one particular fixed income investment manager is authorized to purchase corporate debt issues with a "BBB" rating by S&P to the extent of 25% of the total portfolio if the weighted average rating of the portfolio remains at "AA". Other fixed income securities allowed by the Association are instruments issued by agencies of, or guaranteed by, the U.S. Government; United States Treasury Bonds, Notes and Bills; certificates of deposit and Banker's Acceptances; Commercial paper of the highest quality. No more than 20% of the portfolio managed by one particular investment manager shall be invested in non-U.S. dollar bonds.

As of June 30, 2010, the Association's quality distribution of fixed income investments was as follows:

CREDIT RISK (Continued)

<u>Quality (S&P)</u>	<u>Percentage of Total Fixed Income Securities (Excluding Securities in Mutual Funds)</u>
U.S. Treasury	4.7%
Government Agency	32.5%
AAA	16.2%
AA	3.5%
A	16.1%
BAA	19.4%
BA	3.7%
Other	<u>3.9%</u>
	<u>100%</u>

The above analysis of quality distribution of fixed assets does not include fixed income investments in Pimco Funds. No specific quality or duration data is available from Pimco. Duration does not appear relevant for Pimco Funds because it is a mutual fund and the Association does not own specific fixed income investments in the fund, and shares in the mutual fund owned by the Association have no maturity. The total fair market value of Pimco shares owned by the Association at June 30, 2010 is \$45,164,284. Interest income of \$1,752,672 attributable to Pimco Funds for the Year ended June 30, 2010, includes an undetermined amount of short term capital gains because all earnings of the fund are lumped together and labeled "Dividends & Short-Term Capital Gains" because it is a mutual fund.

INTEREST RATE RISK

Interest rate risk is the risk that changes in the interest rate will adversely affect the fair value of an investment. The Association has not adopted a formal policy to manage interest rate risk.

As of June 30, 2010, the Association had the following fixed income investments:

<u>Investment Type</u>	<u>Fair Value</u>	<u>Weight of Total Fixed Income</u>	<u>Effective Duration (In Years)</u>
U.S. Treasuries	\$ 2,701,252	4.7%	2.3
Government Agencies	4,307,582	7.4%	4.7
Asset-Backed Securities	177,219	.3%	.2
Corporate Bonds	26,635,050	45.9%	5.7
Mortgages	23,003,960	39.6%	2.5
International	1,209,026	2.1%	4.6
Bond Mutual Fund (Pimco)	<u>45,164,284</u>	<u>N/A</u>	N/A
Total Fair Value	<u>\$103,198,373</u>	<u>100.00%</u>	

Portfolio Effective Duration of fixed income securities owned directly by the Association was 4.25 as of June 30, 2010.

HIGHLY SENSITIVE INVESTMENTS

As of June 30, 2010, there were no known investments that were sensitive to interest rate fluctuations.

DERIVATIVES

The Association's investment policy permits the use of derivative instruments to minimize the exposure of certain of its investments to adverse fluctuations in financial and currency markets and enhance yields. The Association does not use derivatives for speculative use or to create leverage.

During the year ended June 30, 2010 The Association had no derivatives in its portfolio.

FOREIGN CURRENCY RISK

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The following tables represent securities held in a foreign currency (in U.S. dollars) as of June 30, 2010:

<u>Local Currency Name</u>	<u>Cash</u>	<u>Equity</u>	<u>Fixed Income</u>	<u>Total</u>
Australian Dollars	\$ 1,280	\$0	\$ 500,841	\$ 502,121
Canadian Dollars	0	0	160,160	160,160
United Kingdom Gilts	0	0	165,733	165,733
New Zealand Dollars	<u>0</u>	<u>0</u>	<u>382,292</u>	<u>382,292</u>
Total	<u>\$ 1,280</u>	<u>\$0</u>	<u>\$1,209,026</u>	<u>\$1,210,306</u>

Foreign currency is comprised of international investment proceeds and income to be repatriated into U.S. dollars and funds available to purchase international securities. Foreign currency is not held as a form of investment, but held temporarily in foreign accounts until it is repatriated or expended.

The investments of the Association are governed primarily by an investment authority known as "The prudent person rule." The prudent person rule, as set forth in Section 31595 of the California Government Code, establishes a standard for all fiduciaries, which includes anyone that has authority with respect to the Association.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Retirement Administrator to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

CONTRIBUTIONS

Actuarially determined member contribution rates averaged 9.85 percent for the year ended June 30, 2010. The actual rate depends on the member's age at the time of hire, whether regular or safety, and tier. Employers are also required to contribute an actuarially determined rate, averaging 10.35 percent of salary for the year ended June 30, 2010. The employers' rate is adjusted periodically to maintain the appropriate funding status of the plan. The recommended rates for employees and employers for the year ended June 30, 2011 are 9.84 and 13.25 percent, respectively. The employer rates are actuarially determined to provide for the balance of the contributions needed to fund the benefits promised (basic and cost of living), and the amortization of the unfunded actuarial accrued liability.

The plan had an unfunded actuarially accrued liability of \$47,154,000 at June 30, 2001. This unfunded liability was being amortized through June 30, 2017, at which time it was anticipated the plan would be fully funded. In December, 1996, the County of Mendocino issued pension obligation bonds, of which \$30,112,488 of the proceeds were contributed to the plan. In December, 2002, due to a continued downward spiral of market values for Association investments, the County of Mendocino issued additional pension obligation bonds. The total of bonds sold was \$92,208,602, of which \$76,299,000 was transferred to the Association for additional investment, \$13,220,061 was used to defease fifty percent of the 1996 pension obligation bonds, and the remainder of \$2,689,541 was used to pay the costs of issuing the bonds. The proceeds from the 2002 pension obligation bonds reduced the unfunded pension liability to less than 10 percent of the actuarially accrued liability at June 30, 2004. The funding agreement in effect prior to July 1, 2009 indicated that the County was not required to fund the unfunded actuarially accrued liability (UAAL) that was not in excess of the target of 10 percent of the total pension liability. In November, 2009 that funding agreement was voided by mutual agreement between the Association Board of Retirement and the Mendocino County Board of Supervisors. Subsequent to the funding agreement, the Board of Retirement stipulated that the County of Mendocino must amortize the UAAL over a 30-year period from June, 2009.

For the actuarial valuation for the year ended June 30, 2010, the actuary changed their assumptions regarding withdrawals by inactive members. This change in assumption affected the projected number of inactive members who would withdraw their contributions and forego a retirement, compared to those who would leave their contributions and vested benefits with the Association and retire at a later date. The actuary formerly used each inactive member's age when determining who would withdraw their funds; now the actuary uses age and years of service for all inactive members. The result was an increase of \$3.3 million in the County's contribution for the fiscal year ended June 30, 2012.

The UAAL as of June 30, 2010 is \$91.8 million, which the County of Mendocino is required to amortize in the future. The funded ratio at June 30, 2010 is 78.9%, as indicated on the Schedule of Funding Progress on Page 23. The information presented in the required supplementary schedules was determined

CONTRIBUTIONS (Continued)

as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation date	June 30, 2010
Actuarial cost method	Entry Age Normal
Asset valuation method	Smoothed Market Value
Actuarial assumptions:	
Investment rate of return*	8%
Interest credited to employees	8%
Projected salary increases*	Standard salary scale
*Includes inflation at	4%
Spouses and Dependents	90% of male employees and 50% of female employees assumed married at retirement, with wives assumed three years younger than husbands.
Rates of employment termination	Standard tables
Years of life expectancy after retirement	Standard tables
Years of life expectancy after disability	Standard tables
Life expectancy after retirement	
For employee contribution rate	
Purposes	General members - 1994 Group Annuity Table for Males, setback 3 years. Safety members - 1994 Group Annuity Table for Males, with no setback.
Reciprocity assumption	50% of members who terminate with a vested benefit are assumed to enter a reciprocal system.
Deferral Age for vested Terminations	62 for general members, 55 for safety.
Sex	All safety members are assumed to be male.

RESERVES

The Association had contingency reserves of \$3,000,426, at June 30, 2010 to fund transfers to retirement reserve accounts in the event that sufficient earnings on investments are not received in the future to fulfill the requirement of transferring current earnings to the extent of 8 percent of retiree reserve balances to those reserves.

Member and employer contributions are allocated to various legally required reserve accounts based on actuarial determinations. A summary of the various reserve accounts, which comprise net assets available for pension and other benefits at June 30, 2010 (under the five-year smoothed market asset valuation method for actuarial valuation purposes) is as follows:

RESERVES (Continued)

Employee reserves	\$ 63,974,619
Employer reserves	-15,617,693
Retiree reserves	250,107,010
Retiree health care benefit reserve	2,448,788
1% contingency reserve	3,000,426
Miscellaneous reserves	<u>3,704</u>
Total reserves	303,916,854
Excess earnings - undesignated	<u>42,288,744</u>
Total allocated reserves (smoothed market actuarial value after corridor limits)	346,205,598
Net assets in excess (deficit) of reserves	<u>(46,163,036)</u>
Net assets available for benefits, at fair value	<u>\$300,042,562</u>

The reserve for health care benefits of retirees was derived from excess earnings of the Association in prior years.

RISK MANAGEMENT

The Association is exposed to various risks of losses related to torts; theft of, damage to and destruction of assets; errors and omissions; injuries to employees; natural disasters; and major downturns in financial markets. For the past several years, the Association has obtained coverage from commercial insurance companies for errors and omissions coverage related to activities of the Board of Retirement, but all other risks of loss, except losses due to depreciation in the fair market value of investments, is assumed by the sponsoring employers. The Association has effectively managed risk through various employee education and prevention programs and careful selection of investments. Expenditures and claims are recognized when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated.

The Mendocino County Department of Human Resources has assumed the duties of administering the health care claims of retirees. The Association no longer pays a flat amount per covered retiree, with the exception of offsetting the County subsidies mentioned above. During the fiscal year ended June 30, 2010 the Association reimbursed the County for claims to health care providers after the health care services were performed and billed. Beginning in the fiscal year ended June 30, 2011 the Association is coming into full compliance with Internal Revenue Code Section 401(h) for any flow of funding.

Based on Mendocino County Board of Supervisors Resolution No. 98-147, County Counsel concluded that the County Board of Supervisors was ultimately responsible for the funding, administration and decision-making dealing with all aspects of the Plan. As a result, no incurred but not reported claims were included as liabilities on the financial statements for the year ended June 30, 2010. For the year ended June 30, 2010, the Association had no excess earnings that can be used for the payment of retiree health benefits.

MEMBER TERMINATION

Upon separation from the Association, members' accumulated contributions are refundable with interest accrued through the prior June 30 or December 31. Interest on member accounts is credited semiannually on June 30 and December 31. Withdrawal of such accumulated contributions results in forfeiture of the related vested benefits.

PLAN TERMINATION

The Association is administered in accordance with the provisions of California Government Code Section 31450 and accompanying code sections. California Government Code Section 31483 allows the governing body of the County, the County Courts, or special district, through the adoption of an ordinance or resolution, to terminate the applicability of the plan to employees of the County, Courts, or district whose services commence after a given future date.

CURRENT AND FUTURE ACCOUNTING PRONOUNCEMENTS

GASB Statement No. 53 - *Accounting and Reporting for Derivative instruments* became effective for all years beginning after June 15, 2009. This statement provides a comprehensive framework for the measurement, recognition, and disclosure of derivative instrument transactions. If the Association invests in derivative instruments in the future, this statement will be used to measure, recognize, and disclose those transactions.

GASB Statement No. 61 - *The Financial Reporting Entity: Omnibus - an amendment of GASB Statements No. 14 and No. 34* modifies certain requirements for inclusion of component units in the financial reporting entity, and amends the criteria for reporting component units as if they were part of the primary government. Although the provisions for this statement are effective for fiscal years beginning after June 15, 2012, it seems to clarify and confirm the existing relationship of the Association as a component unit of the County of Mendocino.

GASB Statement No. 62 - *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This Statement, effective for periods beginning after December 15, 2011, will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source.

SUBSEQUENT EVENTS

Subsequent events are those events or transactions that occur subsequent to the effective date of the financial statements, but prior to the issuance of final reports, which may have a material effect on the financial statements or disclosures therein.

On July 21, 2010 the Board of Retirement approved the writeoff of the \$9,557,912 balance of an account labeled "Actuarial Value of Unrecorded Earnings". The posting of this transaction in a prior year was the result of

SUBSEQUENT EVENTS (Continued)

recording an increase in the Retiree Health Care Benefit Reserve based on actuarial values of assets. Because actuarial values are no longer used as a basis for determining excess earnings, the Association considered this writeoff an important step to acknowledge that significant change in policy.

In late October, 2010 the Association directed the investment managers of separate fixed income accounts to liquidate, or transfer in-kind, all securities. The proceeds or in-kind transfers were placed in the Dodge & Cox Income Fund. As of January 25, 2011 there were no separately managed accounts in the Association portfolio, except for one corporate bond that is being held by the Bank of New York until a proper valuation can be established for disposition. The status of the portfolio will remain the same unless the Board of Retirement takes action to make investments in separately managed accounts.

Subsequent events have been reviewed through the date of this report, January 25, 2011.

EVENT (UNAUDITED) SUBSEQUENT TO THE DATE OF THE INDEPENDENT AUDITOR'S REPORT

During the review of the audited financial statements by the Board of Retirement on February 16, 2011, it was noted that there were questions regarding differences between the audited financial statements, the Management's Discussion and Analysis, and the Report on the Actuarial Valuation as of June 30, 2010. The Board of Retirement has requested these differences be addressed in the notes to the audited financial statements, as follows:

- 1) On page 16 of the Report on Actuarial Valuation, the actuary has indicated a rate of return of 17% for the year ended June 30, 2010, whereas management has indicated a rate of return of 14.47% that was calculated by the investment advisor, Callan Associates, in the Management's Discussion and Analysis on page 6 of the financial report. Management believes the primary difference is due to the actuary's unaudited overstatement of income (see #2).
- 2) On page 24 of the Report on the Actuarial Valuation, the Actuary indicated total investment income of \$44,658,046, whereas the audited financial statements on page 10 of the financial report indicated investment income of \$38,128,443. In addition, the actuary indicated \$299,741,053 as the actual market value of assets at June 30, 2010 on page 24 of the Report on Actuarial Valuation, whereas page 10 of the audited financial statements indicate net assets were \$300,042,562. Management believes the primary reason for the difference in investment income is the inclusion of internal transfers to the insurance claims fund as investment income. Management believes the primary reason for the difference in market value of assets is the actuary's use of unaudited and unadjusted financial data.

Mendocino County Employees' Retirement Association

(A Component Unit of the County of Mendocino)

Required Supplementary Information (Unaudited)

June 30, 2010

Schedule of Funding Progress

(dollar amounts in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) -Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
7/1/05	\$253,487	\$289,467	\$35,980	87.6%	\$57,664	62.4%
7/1/06	\$288,461	\$320,123	\$31,662	90.1%	\$57,665	54.9%
7/1/07	\$317,937	\$358,259	\$40,322	88.7%	\$65,899	61.2%
7/1/08	\$353,421	\$373,832	\$20,411	94.5%	\$70,880	28.8%
7/1/09	\$336,263	\$403,196	\$66,933	83.4%	\$72,235	92.7%
7/1/10	\$343,202	\$434,987	\$91,785	78.9%	\$69,004	133.0%

Schedule of Employer Contributions

(dollar amounts in thousands)

Year Ended	Annual Required Contribution	Percentage Contributed
6/30/05	\$3,221	47%
6/30/06	\$4,996	79%
6/30/07	\$7,533	100%
6/30/08	\$7,232	106%
6/30/09	\$6,046	141%
6/30/10	\$9,571	91%