

DEPARTMENT OF
THE TREASURY
John E. McCormac, CPA
State Treasurer

DIVISION OF PENSIONS
AND BENEFITS
Frederick J. Beaver
Director

POLICE AND FIREMEN'S
RETIREMENT SYSTEM
OF NEW JERSEY

BOARD OF TRUSTEES
as of June 30, 2002

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State Treasurer's Representative

Mark Kandrac

Alan C. Levine

Joseph Boucher

Frank Casey

Kathleen P. Sweeney

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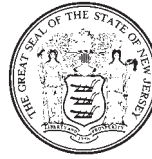
BUCK CONSULTANTS, INC.
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State of New Jersey
DIVISION OF PENSIONS AND BENEFITS
PO Box 295 • Trenton, NJ 08625-0295

TO THE HONORABLE
JAMES E. MCGREEVEY
GOVERNOR of the STATE OF NEW JERSEY

Dear Governor McGreevey:

The Board of Trustees of the

POLICE AND FIREMEN'S
RETIREMENT SYSTEM

is pleased to present the Fiscal Year 2002 Annual Report in accordance with the provisions of N.J.S.A. 43:16A-13.

Respectfully submitted,

A handwritten signature in cursive script that reads "Marty Barrett".

MARTY BARRETT
Chairperson

Police and Firemen's Retirement System
BOARD OF TRUSTEES



Marty Barrett
*Police Representative
Chairperson*



Mark Kandrac
Fire Representative



John Sandella
Fire Representative



Alan C. Levine
Gubernatorial Appointee



Joseph Boucher
Gubernatorial Appointee



Kathleen P. Sweeney
Gubernatorial Appointee



Frank Casey
*Retired Police
Representative*



Frederick J. Beaver
*State Treasurer's
Representative*



Susanne Culliton
*Deputy Attorney General
Legal Advisor*



Wendy Jamison
Board Secretary



Jackie Bussanich
Support Staff

SIGNIFICANT LEGISLATION

CHAPTER 201, P.L. 2001

This law allows police and firefighters who transferred to the Police and Firemen's Retirement System (PFRS) under P.L.1993, c.247 to receive full benefits under PFRS for public safety service rendered prior to the transfer without having to pay the increased cost to the system of providing those benefits. This law applies to both active and retired PFRS members.

P.L.1993, c.247 (C.43:16A-3.8 et seq.) provided for the optional transfer from the Public Employees' Retirement System (PERS) to the PFRS of all municipal police officers and firefighters, plus certain other law enforcement officers, who were not already in PFRS. Chapter 247 provided that a transferring member would receive pro-rated PFRS/PERS benefits upon retirement, unless (1) the member paid to PFRS the full cost (i.e., both the employee's and employer's share) of the accrued liability for the purchased credit, or (2) the voters of the municipality or fire district in which the transferred officer was employed approved a local referendum to adopt PFRS and assume the employer's share of any accrued liability for such transfers.

The new law provides that a PERS member who transferred to PFRS under the 1993 law will automatically receive credit toward full benefits under PFRS for the transferred PERS service. In addition, the law provides that a transferred member who paid the cost for the establishment of full PFRS credit will be reimbursed for that payment.

The additional pension liability created by this law shall be funded by recognizing additional market surplus assets as of June 30, 1999.

This law was approved August 8, 2001 and was effective November 6, 2001.

CHAPTER 228, P.L. 2001

This law permits a member of the Police and Firemen's Retirement System (PFRS) who is laid off from employment as a firefighter and subsequently rehired as a firefighter in a position covered by PFRS to purchase up to three years of service credit for the time between layoff and rehire. The cost of the purchase is to be paid fully by the member and is based on the member's salary for the last 12 months of creditable service immediately preceding the involuntary separation from service.

This law was approved August 27, 2001 and was effective immediately.

CHAPTER 279, P.L. 2001

On February 25, 1997, the Attorney General advised the Department of Personnel and the Division of Pensions and Benefits that the age restrictions for hiring firefighters and for their enrollment in the Police and Firemen's Retirement System (PFRS) were once again in effect as a result of the repeal of a section of the federal Age Discrimination in Employment Act dealing with firefighters and law enforcement officers. This reimposition of hiring restrictions caused problems for individuals who successfully passed civil service examinations prior to the reimposition and were appointed after the reimposition but who were not allowed to join PFRS because of the over age 35 eligibility restriction.

This law provides for membership in the PFRS for an individual over 35 years of age appointed to a uniformed firefighting position of a paid fire department or force if that person was placed on a civil service eligibility list prior to February 25, 1997 and was appointed by a municipal authority prior to June 30, 1998.

This law was approved on December 27, 2001 and was effective immediately.

SIGNIFICANT LEGISLATION, Continued

CHAPTER 293, P.L. 2001

This law makes changes to the mortgage loan program available to members of the Police and Firemen's Retirement System (PFRS). They are eligible for mortgage loans from the retirement system on their principal residences (either new mortgages or the refinancing of existing mortgages). This program was begun in 1992 and is administered by the New Jersey Housing and Mortgage Finance Agency.

Previously, the interest rate was set at two percent above the weekly average yield of one-year United States Treasury securities. This law sets the interest rate at one percent above the weekly average yield of ten-year United States Treasury securities.

The law also provides that if the issuance of ten-year United States Treasury securities is discontinued, the subsequent index will be determined by the State Treasurer with the advice of the New Jersey Housing and Mortgage Finance Agency.

This law was approved on December 28, 2001 and was effective immediately.

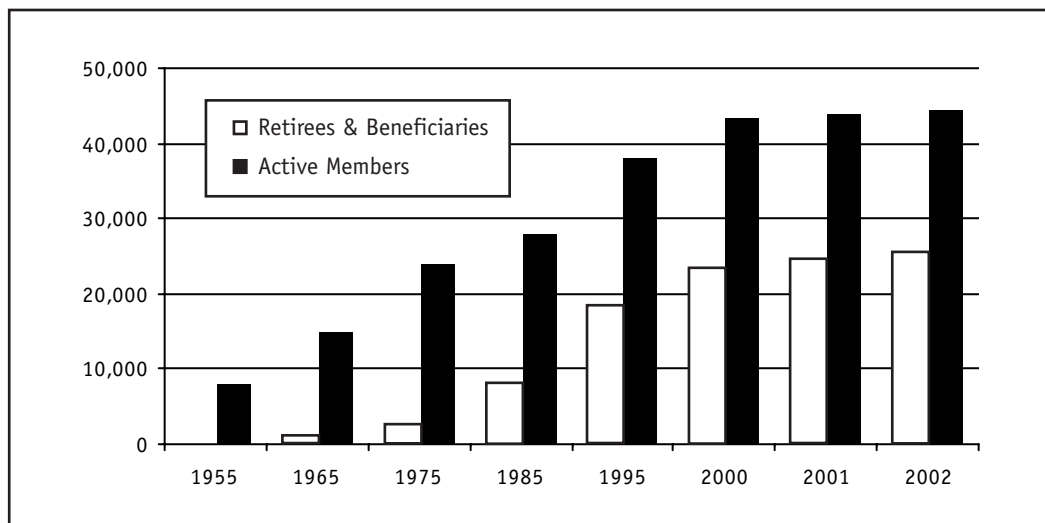
CHAPTER 318, P.L. 2001

This law extends the active death benefits provided in N.J.S.A.43:16A-9, as increased under P.L.1999, c.428, to a widow or widower, child or parent, of a member of the Police and Firemen's Retirement System (PFRS) with ten or more years of PFRS service who died in active service on or after June 1, 1995 and before January 1, 1998 and whose widow or widower had, on May 1, 2001, an appeal of a denial of a benefit related to death in the line of duty pending before the PFRS board of trustees. The law requires that the appeal before the board of trustees have been withdrawn or denied and that an eligible beneficiary apply for the increased benefits within 90 days after the law's enactment and return to PFRS the member's aggregate contributions received. The benefits provided under the law will be prospective only, and not retroactive to the date of death of the member. The State will be liable for all costs to the retirement system attributable to this law.

This law was approved on January 3, 2002 and was effective immediately.

MEMBERSHIP

- As of June 30, 2002, the active membership of the System totaled 44,479. There were 1,943 inactive members in the System as of June 30, 2002.
- There were 25,517 retirees and beneficiaries receiving annual pensions totaling \$823,657,277. *(Includes benefits paid under the provisions of the Pension Adjustment Act.)*
- The System's assets totaled \$15,283,968,390 at the close of the fiscal year 2002.



MEMBERSHIP ACTIVITY

During fiscal year 2002, the following transactions were processed by the Division of Pensions and Benefits on behalf of the membership of the Police and Firemen's Retirement System of New Jersey.

- **LOANS** - 23,900 loans were issued to members. The total loans receivable as of June 30, 2002 is \$468,079,428.
- **RETIREMENT** - 1,152 members retired under the following retirement types:

| <u>TYPE OF RETIREMENT</u> | |
|---------------------------|--------------|
| Service | 44 |
| Special | 813 |
| Deferred | 10 |
| Early | 0 |
| Ordinary Disability | 182 |
| Accidental Disability | 99 |
| Accidental Death | 4 |
| TOTAL | 1,152 |

KPMG LLP
New Jersey Headquarters
150 John F. Kennedy Parkway
Short Hills, NJ 07078

Independent Auditors' Report

The Board of Trustees
State of New Jersey
Police and Firemen's Retirement System:

We have audited the accompanying statements of fiduciary net assets of the State of New Jersey Police and Firemen's Retirement System (the System) as of June 30, 2002 and 2001, and the related statements of changes in fiduciary net assets for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State of New Jersey Police and Firemen's Retirement System as of June 30, 2002 and 2001, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2, the System adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, as of July 1, 2000.

Management's Discussion and Analysis and the supplementary information included in the schedule of funding progress and schedule of employer contributions are not a required part of the financial statements, but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit this information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The schedule of changes in fiduciary net assets by fund is presented for purposes of additional analysis and is not a required part of the financial statements of the System. Such information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

KPMG LLP

September 6, 2002

MANAGEMENT'S DISCUSSION AND ANALYSIS

Police and Firemen's Retirement System

June 30, 2002 and 2001

Our discussion and analysis of the Police and Firemen's Retirement System (the System)'s financial performance provides an overview of the System's financial activities for the fiscal year ended June 30, 2002. Please read it in conjunction with the basic financial statements and financial statement footnotes which follow this discussion.

FINANCIAL HIGHLIGHTS

- Net assets held in trust for pension benefits decreased by \$1,584,284,237 as a result of this year's operations from \$16,789,328,597 to \$15,205,044,360.
- Additions for the year were (\$732,070,913), which are comprised of member and employer pension contributions of \$526,899,685 and investment losses of (\$1,258,970,598).
- Deductions for the year were \$852,213,324, which are comprised of benefit and refund payments of \$848,323,426 and administrative expenses of \$3,889,898.
- The System utilized net assets (excess assets above the required funding level) to meet the State portion of this year's normal pension contribution requirement.

THE STATEMENTS OF FIDUCIARY NET ASSETS AND THE STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS

This annual report consists of two financial statements: *The Statements of Fiduciary Net Assets* and *The Statements of Changes in Fiduciary Net Assets*. These financial statements report information about the System and about its activities to help you assess whether the System, as a whole, has improved or declined as a result of the year's activities. The financial statements were prepared using the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the period they are earned, and expenses are recorded in the year they are incurred, regardless of when cash is received or paid.

The *Statements of Fiduciary Net Assets* show the balances in all of the assets and liabilities of the System at the end of the fiscal year. The difference between assets and liabilities represents the System's fiduciary net assets. Over time, increases or decreases in the System's fiduciary net assets provide one indication of whether the financial health of the System is improving or declining. *The Statements of Changes in Fiduciary Net Assets* show the results of financial operations for the year. The statements provide an explanation for the change in the System's fiduciary net assets since the prior year. These two financial statements should be reviewed along with the information contained in the financial statement footnotes, including the required supplementary schedules, to determine whether the System is becoming financially stronger or weaker.

FINANCIAL ANALYSIS

STATEMENTS OF FIDUCIARY NET ASSETS

The System's assets mainly consist of cash, investments and contributions due from members and participating employers. Between fiscal year 2001 and 2002, total assets decreased by \$1,574,081,610 or 9.3% from \$16,858,050,000 to \$15,283,968,390. The decrease in total assets is mainly due to a loss in the fair value of the System's investments and an increase in benefit payments. During the year, the System had an estimated investment loss of 9.0%.

Liabilities consist of pension and death benefit payments owed to members and beneficiaries, noncontributory

group insurance premiums owed to the System's insurance provider, and other payables. Total liabilities increased by \$10,202,627 or 14.9% over last year from \$68,721,403 to \$78,924,030. This is mainly due to an increase in retirement and insurance benefit payments. In addition, accruals for insurance benefit payments include three months of premium charges and increased by 3.5 million.

Net assets held in trust for pension benefits decreased by \$1,584,284,237 or 9.4% primarily due to the investment losses realized by the System.

STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS

ADDITIONS TO FIDUCIARY NET ASSETS

| | 2002 | 2001 | Increase(Decrease) |
|------------------------|------------------|--------------------|--------------------|
| Member Contributions | \$ 240,012,580 | \$ 228,714,280 | \$ 11,298,300 |
| Employer Contributions | 286,887,105 | 1,295,929 | 285,591,176 |
| Investment & Other | (1,258,970,598) | (1,627,111,009) | 368,140,411 |
| Totals | \$ (732,070,913) | \$ (1,397,100,800) | \$ 665,029,887 |

Additions primarily consist of member and employer contributions and earnings from investment activities. Member contributions rose 4.9% due to normal salary increases and increased membership. Employer contributions recognized by the System increased significantly between fiscal year 2001 and 2002. In fiscal year 2002, employer contributions include \$266.7 million in normal contributions due from local employers in fiscal year 2004. In the prior year, net assets were utilized to cover the local employer contributions that would have been recognized by the System that year. These contributions would have been due the System in fiscal year 2003. In both years, the State's normal contributions were funded using net assets.

For the past several years, net assets have been available to fund, in full or in part, the State and local employer contributions. Net assets (excess assets above the required funding level) have been available mainly due to Pension Security legislation passed in 1997. This legislation authorized the New Jersey Economic Development Authority to issue bonds and to use the proceeds from the bond sale to eliminate the State's portion of the unfunded accrued liabilities of the retirement systems. The System received bond proceeds of \$677,117,660 in 1997. This influx of funds, coupled with investment returns in the late 1990s, has produced excess net assets which have been utilized to partially or fully cover the normal contributions from 1998 through 2002.

For the second consecutive year, the System had an investment loss. In fiscal year 02, the total investment loss for all pension funds was estimated to be 9.0% compared to 10.4% in the prior year.

DEDUCTIONS FROM FIDUCIARY NET ASSETS

| | 2002 | 2001 | Increase(Decrease) |
|-------------------------|----------------|----------------|--------------------|
| Benefits | \$ 842,051,581 | \$ 766,422,862 | \$ 75,628,719 |
| Refunds & Adjustments | 6,271,845 | 156,537,567 | (150,265,722) |
| Administrative Expenses | 3,889,898 | 2,762,465 | 1,127,433 |
| Totals | \$ 852,213,324 | \$ 925,722,894 | \$ (73,509,570) |

Deductions are mainly comprised of pension benefit payments to retirees and beneficiaries, refunds of contributions to former members and administrative costs incurred by the System. Benefit payments increased primarily because more members are receiving benefits. Refunds and adjustments reflect the impact of Chapter 44, P.L. 2001. This legislation reduced the local employer contributions payable in fiscal year 2001 by \$149 million from \$225 million to \$76 million. Since the System recognized in fiscal year 1999 the amount originally owed by the local employers, a \$149 million employer contribution adjustment was recorded in fiscal year 2001. The number

of refunds processed has decreased compared to last year due to fewer terminations. Administrative expenses have increased mainly due to contractual increases in salaries and higher fringe benefit costs.

RETIREMENT SYSTEM AS A WHOLE

The overall funded ratio of 100.9% indicates that the System has assets sufficient to meet its benefit obligations now and in the future.

CONTACTING SYSTEM FINANCIAL MANAGEMENT

The financial report is designed to provide our members, customers, investors and other interested parties with a general overview of the System's finances and to show the System's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Division of Pensions and Benefits, P.O. Box 295, Trenton, NJ 08625-0295.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Statements of Fiduciary Net Assets

June 30, 2002 and 2001

| | 2002 | 2001 |
|---------------------------------------|-------------------|----------------|
| Assets: | | |
| Cash | \$ — | 55,175,268 |
| Investments, at fair value: | | |
| Cash Management Fund | 318,445,673 | 751,241,511 |
| Bonds | 18,198,484 | 22,588,163 |
| Common Pension Fund A | 6,459,001,400 | 7,708,404,822 |
| Common Pension Fund B | 3,554,435,308 | 3,723,401,385 |
| Common Pension Fund D | 2,376,552,698 | 2,545,811,336 |
| Mortgages | 1,410,456,805 | 1,225,056,412 |
| Total investments | 14,137,090,368 | 15,976,503,629 |
| Receivables: | | |
| Contributions: | | |
| Members | 44,799,031 | 42,644,881 |
| Employers | 532,733,506 | 247,620,395 |
| Accrued interest and dividends | 86,991,470 | 87,019,545 |
| Members' loans | 468,079,428 | 442,706,147 |
| Other | 14,274,587 | 6,380,135 |
| Total receivables | 1,146,878,022 | 826,371,103 |
| Total assets | 15,283,968,390 | 16,858,050,000 |
| Liabilities: | | |
| Accounts payable and accrued expenses | 1,764,845 | 1,240,076 |
| Retirement benefits payable | 70,611,067 | 65,479,310 |
| NCGI premiums payable | 4,958,494 | 2,002,017 |
| Cash Overdraft | 1,589,624 | — |
| Total liabilities | 78,924,030 | 68,721,403 |
| Net Assets: | | |
| Held in trust for pension benefits | \$ 15,205,044,360 | 16,789,328,597 |

See schedule of funding progress on page 18.

See accompanying notes to financial statements.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM
Statements of Changes in Fiduciary Net Assets
Years ended June 30, 2002 and 2001

| | 2002 | 2001 |
|-----------------------------------------------------------------|-------------------|-----------------|
| Additions: | | |
| Contributions: | | |
| Members | \$ 240,012,580 | 228,714,281 |
| Employers | 286,887,105 | 1,295,929 |
| Total contributions | 526,899,685 | 230,010,210 |
| Investment Income | | |
| Net (depreciation) appreciation in fair value of investments | (1,758,360,537) | (2,204,644,186) |
| Interest | 402,532,105 | 490,611,889 |
| Dividends | 98,248,724 | 88,348,730 |
| | (1,257,579,708) | (1,625,683,567) |
| Less investment expense | 1,390,890 | 1,427,442 |
| Net investment income | (1,258,970,598) | (1,627,111,009) |
| Total additions | (732,070,913) | (1,397,100,799) |
| Deductions: | | |
| Benefits | 842,051,581 | 766,422,862 |
| Refunds of contributions | 6,271,845 | 7,333,445 |
| Adjustment to employer receivable | — | 149,204,122 |
| Administrative expenses | 3,889,898 | 2,762,465 |
| Total deductions | 852,213,324 | 925,722,894 |
| Change in net assets | (1,584,284,237) | (2,322,823,693) |
| Net assets - Beginning of year | 16,789,328,597 | 19,112,152,290 |
| Net assets - End of year | \$ 15,205,044,360 | 16,789,328,597 |

See accompanying notes to financial statements.

**STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements

June 30, 2002 and 2001

(1) DESCRIPTION OF THE SYSTEM

State of New Jersey Police and Firemen's Retirement System (the System) is a cost-sharing multiple-employer contributory defined benefit plan which was established as of July 1, 1944, under the provisions of N.J.S.A. 43:16A. The System is included along with other state-administered pension trust and agency funds in the basic financial statements of the State of New Jersey.

At June 30, 2001, the date of the most recent actuarial valuation, and June 30, 2000, participating employers consisted of the following:

| | 2001 | 2000 |
|---------------------|-------------|-------------|
| State of New Jersey | 1 | 1 |
| Municipalities | 584 | 580 |
| Total | 585 | 581 |

The System's designated purpose is to provide retirement, death and disability benefits to its members. Membership in the System is mandatory for substantially all full-time county and municipal police or firemen, and state firemen or officer employees with police powers appointed after June 30, 1944. The System's Board of Trustees is primarily responsible for its administration.

According to State of New Jersey Administrative Code, all obligations of the System will be assumed by the State of New Jersey should the System terminate.

Vesting and Benefit Provisions:

The vesting and benefit provisions are set by N.J.S.A. 43:16A and 43:3B. The System provides retirement as well as death and disability benefits. All benefits vest after ten years of service except disability benefits which vest after four years of service. Retirement benefits for age and service are available at age 55 and are generally determined to be 2% of final compensation for each year of creditable service, as defined, up to 30 years plus 1% for each year of service in excess of 30 years. Final compensation equals the compensation for the final year of service prior to retirement. Members may seek special retirement after achieving 25 years of creditable service or they may elect deferred retirement after achieving ten years of service, in which case benefits would begin at age 55 equal to 2% of final compensation for each year of service. The annual benefit under special retirement is 65% of the member's final compensation plus 1% for each year of creditable service over 25 years but not to exceed 30 years. The maximum allowance is therefore 70 percent of final compensation.

Widow/widowers of members retired since December 18, 1967 receive 50% of the retiree's final compensation. The minimum annual widow/widower's benefits of an accidental disability retiree prior to December 18, 1967 and of all retirees since December 18, 1967 is \$4,500.

Members are always fully vested for their own contributions. In the case of death before retirement, members' beneficiaries are entitled to full payment of members' contributions providing no survivor death benefits are payable.

**STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements, Continued

(1) DESCRIPTION OF THE SYSTEM, Continued

Eligible retirees receiving monthly benefits are entitled to cost-of-living increases equal to 60% of the change in the average consumer price index for the calendar year in which the pensioner retired as compared to the average consumer price index for a 12-month period ending with each August 31st immediately preceding the year in which the adjustment becomes payable. The regular retirement allowance is multiplied by the 60% factor as developed and results in the dollar amount of the adjustment payable. Retired members become eligible for pension adjustment benefits after 24 months of retirement. The cost-of-living increases are funded by the retirement system and are included in the annual actuarial calculations of the required state and state-related employer contributions.

Legislation passed during the year (Chapter 4, P.L. 2001) provides increased benefits to certain members who retired prior to December 29, 1989 with at least 25 years of creditable service. The maximum amount of the increase is 5% of the retiree's final compensation. For those with 30 or more years of service, the total pension would increase from 65% to 70% of final compensation.

Membership:

Membership in the System consisted of the following at June 30:

| | 2001 | 2000 |
|----------------------------------------------------------------------------------------------------------------------------------|-------------|-------------|
| Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them | 24,379 | 23,091 |
| Active members: | | |
| Vested | 25,961 | 25,969 |
| Non-vested | 17,058 | 16,461 |
| Total active members | 43,019 | 42,430 |
| Total | 67,398 | 65,521 |

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Measurement Focus and Basis of Accounting:

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. The System is accounted for using an economic resources measurement focus. The System that focuses on total economic resources employs the accrual basis of accounting, which recognizes increases and decreases in economic resources as soon as the underlying event or transaction occurs.

The accrual basis of accounting is used for measuring financial position and changes in fiduciary net assets of the System. Under this method, revenues are recorded in the accounting period in which they are earned and deductions are recorded at the time the liabilities are incurred. The financial statements of the System conform to the provisions of Governmental Accounting Standards Board (GASB) Statement No. 25, "Financial Reporting for Defined Benefit Plans and Note Disclosures for Defined Contributions Plans" and No. 26, "Financial Reporting for Post-employment Healthcare Plans Administered by Defined Benefit Pension Plans."

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Notes to Financial Statements, Continued

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Plan assets are recorded at fair value. Employer contributions are recognized when payable to the System. Benefits and refunds are recognized when payable in accordance with the terms of the System.

New Accounting Standards Adopted:

Effective July 1, 2000, the Division adopted two new statements of financial accounting standards issued by the Governmental Accounting Standards Board (GASB):

Statement No. 34 *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*

Statement No. 37 *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*

Statement No. 34 (as amended by Statement No. 37) requires as required supplementary information Management's Discussion and Analysis which includes an analytical overview of the System's financial activities.

Investment Valuation:

Investments, including short-term investments (State of New Jersey Cash Management Funds) 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. Mortgages 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.

The State of New Jersey Division of Investment, under the jurisdiction of the State Investment Council, has the investment responsibility for all funds administered by the State of New Jersey Division of Pensions and Benefits. All investments must conform to standards set by state law.

The State of New Jersey Division of Investment administers three common pension funds which are utilized by the System. A brief description of each common pension fund is as follows:

Common Pension Fund A - The operations of Common Pension Fund A are governed by the provisions of Article 62 of the State of New Jersey Investment Council regulations for the purpose of investing in corporate common stocks, securities convertible into corporate common stocks or covered call options.

Common Pension Fund B - The operations of Common Pension Fund B are governed by the provisions of Article 63 of the State of New Jersey Investment Council regulations for the purpose of investing in fixed income and debt securities.

Common Pension Fund D - The operations of Common Pension Fund D are governed by the provisions of Article 67 of the State of New Jersey Investment Council regulations for the purpose of investing in international debt and equity securities, currencies, currency futures, and options.

The State of New Jersey, Department of the Treasury, Division of Investment, issues publicly available financial reports that include the financial statements of the State of New Jersey Cash Management Funds, Common Pension Fund A, Common Pension Fund B and Common Pension Fund D. The financial reports may

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Notes to Financial Statements, Continued

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

be obtained by writing to the State of New Jersey, Department of the Treasury, Division of Investment, P.O. Box 290, Trenton, New Jersey 08625-0290.

The purchase, sale, receipt of income, and other transactions affecting investments are governed by custodial agreements between the System, through the State Treasurer, and custodian banks as agents for the System. State laws and policies set forth the requirements of such agreements and other particulars as to the size of the custodial institutions, amount of the portfolio to be covered by the agreements, and other pertinent matters.

GASB Statement No. 3 requires disclosure of the level of custodial risk assumed by the System. Category 1 includes investments that are insured or registered or for which the securities are held by the System or its agent in the System's name. As of June 30, 2002 and 2001, all investments held by the System (other than mortgages and the State of New Jersey Cash Management Funds which are not categorized) are classified as Category 1.

Federal securities are maintained at Federal Reserve Banks in Philadelphia and New York through the custodian banks in trust for the System. A significant portion of corporate equity and debt securities are maintained by the Depository Trust Company (DTC) through the custodian banks in trust for the System. The custodian banks as agents for the System maintain internal accounting records identifying the securities maintained by the Federal Reserve Banks and the DTC as securities owned by or pledged to the System.

Securities not maintained by the Federal Reserve Banks or DTC are in the name of a designated nominee representing the securities of the System, which establishes the System's unconditional right to the securities.

Members' Loans:

Members can borrow up to 50% of their accumulated member contributions. To obtain a loan, a member must have at least three years of service credit in the System. Repayment of loan balances is deducted from payroll checks and bears an interest rate of 4%. Members who retire with an outstanding loan have the option of paying the loan in full prior to receiving any benefits or continuing their monthly loan repayment schedule into retirement.

Administrative Expenses:

The System is administered by the State of New Jersey Division of Pensions and Benefits. Administrative expenses are paid by the System to the State of New Jersey, Department of the Treasury and are included in the accompanying statements of changes in fiduciary net assets.

Cash and Cash Equivalents:

GASB Statement No. 3 also requires that deposits held in financial institutions be categorized to indicate the level of risk assumed by the entity. Category 1 consists of deposits that are insured or collateralized with securities held by the entity or by its agent in the entity's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name. Category 3 consists of deposits which are uninsured and uncollateralized.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Notes to Financial Statements, Continued

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Based upon aggregate collateral levels maintained for all state bank accounts as a whole, substantially all cash balances maintained in financial institutions as of June 30, 2002, which include funding for the July 1, 2002 retirement payroll, are designated Category 3.

The categorization of cash and cash equivalents for all state funds, including the pension trust funds, can be found in the notes to the general purpose financial statements of the State of New Jersey.

(3) CONTRIBUTIONS

The contribution policy is set by N.J.S.A. 43:16A and requires contributions by active members and contributing employers. Plan member and employer contributions may be amended by State of New Jersey legislation. Employers are required to contribute at an actuarially determined rate. The annual employer contribution includes funding for basic retirement allowances, cost-of-living adjustments, and noncontributory death benefits. Members contribute at a uniform rate of 8.5% of base salary.

Chapter 115, P.L. 1997 provides for the use of excess valuation assets to fund required normal contributions. Through fiscal year 2002, excess valuation assets may be used to the extent possible to offset normal employer contributions. Thereafter, a certain percentage of available excess valuation assets may be used as specified in the legislation.

In 2002 and 2001, excess valuation assets were utilized to fund required State contributions of \$107,098,598 and \$99,607,041, respectively.

In 2002, actuarially determined excess valuation assets also covered required local employer contributions of \$268,105,237. In accordance with legislation passed in 2001 (Chapter 44, P.L. 2001), excess valuation assets were recognized to reduce 2001 local employer contributions by \$150 million to approximately \$76 million. This legislation required that the savings realized by counties and municipalities as a result of this reduction be used for property tax relief.

(4) FUNDS

This System maintains the following legally required funds:

Members' Annuity Savings Fund (2002 - \$1,993,220,376; 2001 - \$1,856,937,300)

The Members' Annuity Savings Fund (ASF) is credited with all contributions made by active members of the System.

Pension Accumulation Fund (2002 - \$6,085,389,342; 2001 - \$8,203,828,815)

The Pension Accumulation Fund is credited with the contributions of the State of New Jersey and other employers. Interest earnings, after crediting the ASF and the Retirement Reserve Fund, as required, are credited to this account. Additionally, payments for life insurance premiums are made from this Fund.

Retirement Reserve Fund (2002 - \$7,126,434,642; 2001 - \$6,728,562,482)

The Retirement Reserve Fund is the account from which retirement benefits other than life insurance premiums, including cost-of-living benefits, are paid. Upon retirement of a member, accumulated contributions are transferred to the Retirement Reserve Fund from the Annuity Savings Fund. Any reserves needed

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Notes to Financial Statements, Continued

(4) FUNDS, Continued

to fund the balance of the retirement benefit are transferred from the Pension Accumulation Fund. Annually, interest as determined by the State Treasurer (8.75% for 2001 and 2000) is credited to the Retirement Reserve Fund.

Special Reserve Fund (2002 - \$0; 2001 - \$0)

The Special Reserve Fund is a fund to which any excess interest earnings and gains from sales and maturities of investments are transferred and against which any losses from the sales of securities are charged. The maximum limit on the accumulation of this account is 1% of the market value of the investments of the System. Amounts in excess of 1% are credited to the Pension Accumulation Fund.

(5) INCOME TAX STATUS

Based on a 1986 declaration of the Attorney General of the State of New Jersey, the System is a qualified plan as described in Section 401(a) of the Internal Revenue Code.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Required Supplementary Information

Schedule of Funding Progress

| ACTUARIAL VALUATION DATE | ACTUARIAL VALUE OF ASSETS (a) | ACTUARIAL ACCRUED LIABILITY (b) | UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY (b - a) | FUNDED RATIO (a / b) | COVERED PAYROLL (c) | UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY AS A PERCENTAGE OF COVERED PAYROLL ((b - a) / c) |
|--------------------------------|----------------------------------------|------------------------------------------|--------------------------------------------------------------------------|----------------------------|---------------------------|----------------------------------------------------------------------------------------------------------------------------|
| June 30, 1996 | \$10,959,178,731 | \$12,076,365,067 | \$1,117,186,336 | 90.7% | \$1,967,863,025 | 56.8% |
| State | | | | | | |
| June 30, 1997 | 1,183,747,522 | 1,234,959,165 | 51,211,643 | 95.9% | 315,690,310 | 16.2% |
| June 30, 1998 | 1,559,131,933 | 1,377,734,455 | (181,397,478) | 113.2% | 346,079,078 | (52.4%)* |
| June 30, 1999 | 1,717,248,151 | 1,534,470,501 | (182,777,650) | 111.9% | 362,949,950 | (50.4%)* |
| June 30, 2000 | 1,884,870,936 | 1,666,842,906 | (218,028,030) | 113.1% | 363,360,250 | (60.0%)* |
| June 30, 2001 | 1,991,299,968 | 1,866,140,391 | (125,159,577) | 106.7% | 398,118,379 | (31.4%)* |
| Local | | | | | | |
| June 30, 1997 | 10,854,173,290 | 11,746,169,752 | 891,996,462 | 92.4% | 1,767,762,346 | 50.5% |
| June 30, 1998 | 13,169,957,658 | 12,881,842,367 | (288,115,291) | 102.2% | 1,870,322,787 | (15.4%)* |
| June 30, 1999 | 14,536,570,357 | 13,894,951,617 | (641,618,740) | 104.6% | 1,971,087,124 | (32.6%)* |
| June 30, 2000 | 15,644,750,281 | 14,924,699,712 | (720,050,569) | 104.8% | 2,055,781,766 | (35.0%)* |
| June 30, 2001 | 16,083,153,842 | 16,056,446,646 | (26,707,196) | 100.2% | 2,163,590,060 | (1.2%)* |

*Adjusted to reflect the impact of legislation passed in fiscal year 2001 which retroactively affected the June 30, 1999 and 1998 valuations. Chapter 4, P.L. 2001 provides benefit enhancements for certain eligible members who retired prior to December 29, 1989. The unfunded accrued liability attributable to the increased benefits was exactly offset by the recognition of an additional amount of market value of assets in the determination of the actuarial value of assets for the July 1, 1999 valuation. Chapter 44, P.L. 2001, referred to in Note 3, reduced the contribution of local employers by \$149 million.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Required Supplementary Information, Continued

Schedule of Funding Progress - Additional Actuarial Information

Significant actuarial methods and assumptions used in the most recent June 30, 2001 and 2000 actuarial valuations included the following:

| | June 30, 2001 | June 30, 2000 |
|-------------------------------|--------------------------------|--------------------------------|
| Actuarial cost method | Projected unit credit | Projected unit credit |
| Asset valuation method | 5 year average of market value | 5 year average of market value |
| Amortization method | Level percent, closed | Level percent, closed |
| Remaining amortization period | 30 years | 31 years |
| Actuarial assumptions: | | |
| Interest rate | 8.75% | 8.75% |
| Salary range | 5.95% | 5.95% |
| Cost-of-living adjustments | 2.40% | 2.40% |

The actuarial assumptions used in the June 30, 2001 and 2000 valuations reflect the actuarial assumptions developed from the three year experience investigation for the period ending June 30, 1998.

Annual covered payroll is an estimate based upon annualizing one quarter's actual payroll.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM
 Required Supplementary Information, Continued
 Schedule of Employer Contributions

| STATE | | | |
|------------------------------------|---------------------------------------------|-----------------------------------|-----------------------------------|
| YEAR ENDED JUNE 30, | ANNUAL REQUIRED CONTRIBUTION | EMPLOYER CONTRIBUTIONS | PERCENTAGE CONTRIBUTED |
| 1997 | \$ 111,775,028 | \$ 715,344,385 ⁽²⁾ | 640.0% |
| 1998 | 84,167,834 | 73,587,848 ⁽³⁾ | 87.4% |
| 1999 | 93,920,617 | 23,730,087 ⁽³⁾ | 25.3% |
| 2000 | 98,974,449 | 60,521,749 ⁽³⁾ | 61.1% |
| 2001 | 95,883,272 | — ⁽³⁾ | 0.0% |
| 2002 | 103,580,989 | — ⁽³⁾ | 0.0% |

| LOCAL | | | |
|------------------------------------|---------------------------------------------|-------------------------------------------------|-----------------------------------|
| YEAR ENDED JUNE 30, | ANNUAL REQUIRED CONTRIBUTION | EMPLOYER CONTRIBUTIONS⁽¹⁾ | PERCENTAGE CONTRIBUTED |
| 1997 | \$ 250,220,580 | \$ 234,963,865 | 93.9% |
| 1998 | 238,002,765 | 223,491,008 | 93.9% |
| 1999 | 273,210,113 | 256,551,862 | 93.9% |
| 2000 | 275,790,739 | 214,164,848 | 77.7% |
| 2001 | 249,746,232 | 75,670,018 | 30.3% |
| 2002 | 248,754,078 | 185,415 ⁽³⁾ | 0.1% |

Notes to Schedule:

- (1) Local employer contributions include contributions made by the State to provide funding for certain benefits payable to local participants.
- (2) For the year ended June 30, 1997, the state portion of employer contributions exceeded the annual required contributions as a result of legislation that was enacted (Chapter 114, P.L. 1997), authorizing the New Jersey Economic Development Authority to issue bonds, notes or other obligations for the purpose of financing, in full or in part, the State of New Jersey's portion of the unfunded accrued liability under the State of New Jersey retirement systems.
- (3) In accordance with Chapter 115, P.L. 1997, all or a portion of the required contribution was funded by available excess valuation assets.

STATE OF NEW JERSEY
POLICE AND FIREMEN'S RETIREMENT SYSTEM

Schedule of Changes in Fiduciary Net Assets by Fund
Year ended June 30, 2002

| | MEMBERS' ANNUITY SAVINGS FUND | PENSION ACCUMULATION FUND | RETIREMENT RESERVE FUND | SPECIAL RESERVE FUND | TOTAL |
|---------------------------------------------------------|-------------------------------------|---------------------------------|-------------------------------|----------------------------|-----------------|
| Additions: | | | | | |
| Contributions: | | | | | |
| Members | \$ 240,012,580 | — | — | — | 240,012,580 |
| Employers | — | 286,887,105 | — | — | 286,887,105 |
| Total contributions | 240,012,580 | 286,887,105 | — | — | 526,899,685 |
| Distribution of net investment income | — | (1,847,719,815) | 588,749,217 | — | (1,258,970,598) |
| Total additions | 240,012,580 | (1,560,832,710) | 588,749,217 | — | (732,070,913) |
| Deductions: | | | | | |
| Benefits | — | 18,394,304 | 823,657,277 | — | 842,051,581 |
| Refunds of contributions | 5,881,319 | 390,526 | — | — | 6,271,845 |
| Administrative expenses | — | 3,889,898 | — | — | 3,889,898 |
| Total deductions | 5,881,319 | 22,674,728 | 823,657,277 | — | 852,213,324 |
| Net increase (decrease) before transfers among reserves | | | | | |
| | 234,131,261 | (1,583,507,438) | (234,908,060) | — | (1,584,284,237) |
| Transfers among reserves: | | | | | |
| Retirements | (99,193,546) | (539,816,760) | 639,010,306 | — | — |
| Other | 1,345,361 | 4,884,725 | (6,230,086) | — | — |
| Net increase (decrease) | 136,283,076 | (2,118,439,473) | 397,872,160 | — | (1,584,284,237) |
| Net assets held in trust for pension benefits: | | | | | |
| Beginning of year | 1,856,937,300 | 8,203,828,815 | 6,728,562,482 | — | 16,789,328,597 |
| End of year | \$ 1,993,220,376 | 6,085,389,342 | 7,126,434,642 | — | 15,205,044,360 |

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