Financial Audit of the Hawaii Public Employees Health Fund

A Report to the Governor and the Legislature of the State of Hawaii

Report No. 99-18
April 1999

THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

THE AUDITOR
STATE OF HAWAII
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OVERVIEW

Financial Audit of the Hawaii Public Employees Health Fund

Report No. 99-18, April 1999

Summary

The Office of the Auditor and the certified public accounting firm of Deloitte & Touche, LLP conducted a financial audit of the Hawaii Public Employees Health Fund (Health Fund) for the fiscal year July 1, 1997 to June 30, 1998.

Because the Health Fund did not account for its financial activities in an enterprise fund as required by generally accepted accounting principles and because gain contingencies have been recorded in the financial statements, in the opinion of Deloitte & Touche LLP, based on their audit, the financial statements do not present fairly the financial position of the Health Fund at June 30, 1998, and the results of its operations for the year ended in conformity with generally accepted accounting principles. In addition, the Health Fund's management declined to provide us with a written representation letter required by generally accepted auditing standards. This raises serious questions about its responsibility for and accuracy of financial information provided about the Health Fund.

We found several deficiencies in the financial accounting and internal control practices of the Health Fund. One deficiency was serious enough that the auditors expressed an adverse opinion on the Health Fund's financial statements. An adverse opinion is the worst possible opinion issued by CPA firms.

The Health Fund's failure to follow proper accounting and financial reporting standards resulted in approximately $294 million of revenues and $203 million of expenses not recorded and reported by the fund. In addition, the Health Fund incorrectly recorded $17.4 million in underwriting gains, as well as $2.1 million of related interest income, as assets as of June 30, 1998.

We also found that a lack of clarity between the Health Fund and its insurance carriers as to the definition and measurement of rate stabilization reserves has resulted in substantial excess reserves. Total reserves held by insurance carriers amounted to approximately $86 million as of June 30, 1998.

We also found that interest income earned on the reserves held by the insurance carriers is not being monitored. With one exception, the Health Fund has no agreements with the insurance carriers that specify the interest rates to be used on the reserves held by the carriers or any reporting requirements. Interest income of only $2.5 million or about 2.9 percent was reported by the Health Fund as of June 30, 1998 on the over $86 million held by the carriers.

We also found that the majority of agreements with the insurance carriers to provide health care benefits in fiscal year 1998 were unsigned, thus placing the fund and the State at risk.

Finally, the Health Fund has been unable to implement a long-term care insurance benefit plan, nor has it been able to return excess premiums in the millions of dollars to employees as required by state law.

Recommendations and Response

We recommend that the Health Fund comply with state law and account for and report its financial activities as required by generally accepted accounting principles. We also recommend that management clarify the definition of a rate stabilization reserve, enforce the provisions of the contracts with the insurance carriers on the return of excess reserves to the State, and negotiate adequate interest rate earnings on reserves held by insurance carriers. In addition, management should negotiate the minimum interest rates to be earned by the carriers, and require the carriers to provide a quarterly report on the interest earned and reserve amounts held.

In addition, we recommend that the Health Fund ensure that contracts with insurance carriers are timely and properly executed. The Health Fund management should work more closely with the Legislature and the Departments of Budget and Finance and the Attorney General in resolving the issues relating to (a) the adoption of a long-term care insurance benefit plan and (b) the disposition of excess reserves created by employee contributions.

The Department of Budget and Finance responded by providing rationale for the delay in implementing a long-term care insurance benefit plan. In addition, it provided information on a current legislative request that proposes to implement this insurance benefit plan.

The Health Fund indicates that the board of trustees is unable to fully respond to all of the findings because of the short time frame but will continue to evaluate the findings and respond at some future public hearing.

The Health Fund believes that although the accounting standards "may be technically correct," its financial transactions present a better picture of its operations under the current fund reporting. We disagree, the current financial reporting of the Health Fund does not comply with the generally accepted accounting principles. The principles enable everyone to compare the performance of such entities as health funds and be able to rely on financial statements.

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State Auditor
State of Hawaii

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Financial Audit of the Hawaii Public Employees Health Fund

A Report to the Governor and the Legislature of the State of Hawaii

Conducted by

The Auditor
State of Hawaii
and
Deloitte & Touche LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 99-18
April 1999

Foreword

This is a report of the financial audit of the Hawaii Public Employees Health Fund for the fiscal year July 1, 1997 to June 30, 1998. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Deloitte & Touche, LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the health fund and administration of the Department of Budget and Finance.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

This is a report on our financial audit of the Hawaii Public Employees Health Fund (Health Fund). The audit was conducted by the Office of the Auditor (Auditor) and the independent certified public accounting firm of Deloitte & Touche LLP.

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background

The Health Fund was established by Chapter 87, Hawaii Revised Statutes, to provide health and group life insurance benefits to eligible, active, state and county employees, retirees, their dependents, and reciprocal beneficiaries. Available benefits include medical, dental, prescription drug, vision, life insurance, and a Medicare supplemental plan.

The Health Fund is administratively attached to the Department of Budget and Finance. A nine-member board of trustees (Board) appointed by the governor is responsible for the fund's oversight. The Board negotiates employee benefit plan contracts with insurance carriers and oversees enrollment and financial operations.

Public employers pay the entire monthly health care premium for employees retiring with ten or more years of credited service, and 50 percent of the monthly premium for eligible employees retiring with fewer than ten years of credited service. Retirees enrolled in both the federal Medicare plan and the Health Fund's Medicare supplemental plan receive a monthly Medicare Part B reimbursement from the Health Fund. Spouses also participate in these benefits.

Eligible employees and retirees can enroll in plans provided by the Health Fund or in union-sponsored health benefit plans. The Health Fund administers contracts with seven insurance carriers to provide health and insurance benefits. Sixteen employee organizations or unions also sponsor such plans for their members. For these plans, the Health Fund directs or ports employer and employee contributions to the unions.

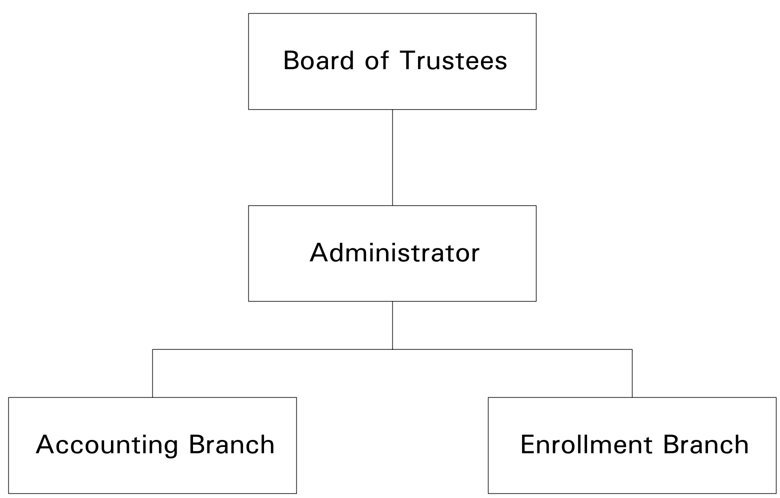
As of June 30, 1998, the Health Fund provided health and group life insurance benefits to approximately 145,000 individuals: 59,000 active employees; 29,000 retirees; 25,000 spouses; and 32,000 dependents under the age of 19.

For the year ended June 30, 1998, the Health Fund paid approximately $203 million in premiums to insurance carriers.

Organization of the Health Fund

The Health Fund is managed by an administrator and a staff consisting of 15 personnel in the enrollment and accounting branches. Exhibit 1.1 displays the organizational chart of the Health Fund.

Exhibit 1.1
Organizational Chart of the Hawaii Public Employees Health Fund



The administrator is responsible for executing board policies, rules and regulations (including program performance reports). The administrator also manages program activities of the enrollment and accounting branches (including program policy and procedural changes). He authorizes reinstatement and cancellation of enrollments, renders decisions on employee appeals, directs training programs for state personnel officers, monitors benefit plan contract administration, and performs liaison services for carriers, employers, unions, and state, county, and federal agencies. In addition, the administrator authorizes payment of death claims for the Health Fund's life insurance plan and testifies at the Legislature on bills, resolutions, and issues affecting the program.

The enrollment branch is responsible for conducting eligibility audits according to rules and regulations; processing and maintaining documents for new enrollments, changes, reinstatements, terminations and cancellations; and communicating rules, policies and procedures to carriers, employees, and employers. The branch also trains state and county personnel and fiscal officers how to enroll their respective employees and retirees in fringe benefit plans. In addition, the branch conducts informational briefings for employees and retirees. After initial certification of benefit eligibility by the Employees' Retirement System of the State of Hawaii, the branch provides services for enrollment changes of state and county retirees. The branch also researches employees' complaints and appeals, prepares Medicare Part B medical insurance reimbursements to eligible retirees and spouses, administers the State of Hawaii's Premium Conversion Plan, and administers the federal COBRA benefits program.

The accounting branch is responsible for preparing budgets and financial statements; determining and notifying employers of monthly contribution rates and payments due; and notifying employees of premium shortages, benefit plan suspensions, reinstatements, and cancellations. The accounting branch also collects and reconciles employee deductions and employer contributions in accordance with statutes and collective bargaining agreements, maintains and reconciles reserves, and remits premiums to insurance carriers and employee organizations. The branch is responsible for executing disbursements of the Health Fund Life Insurance Plan proceeds to beneficiaries and for issuing Medicare Part B health insurance reimbursements. The branch maintains communication with insurance carriers, employee organizations, unions, and state and county departmental personnel and fiscal officers, and employers.

Objectives of the Audit

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the Health Fund; to recommend improvements to such systems, procedures, and reports; and to report on the financial statements of the Health Fund.

2. To ascertain whether expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

3. To make recommendations as appropriate.

Scope and Methodology

The Auditor's contract with Deloitte & Touche LLP requires an audit of the financial records and transactions and a review of the related systems of accounting and internal controls of the Health Fund for the fiscal year July 1, 1997 to June 30, 1998. Included in the scope of work were all fund types and account groups except for the general fixed assets account group. The contract also provides for review of the Health Fund's transactions, systems, and procedures for compliance with applicable laws and regulations.

To the extent possible, we examined the existing accounting, reporting and internal control structure. We identified deficiencies and weaknesses in the internal control structure and made recommendations for improvement.

The independent auditors' report on the combined financial statements presented in Chapter 3 is that of Deloitte & Touche LLP. The work was conducted from July 1998 through December 1998 in accordance with generally accepted government auditing standards.

Chapter 2

Internal Control Deficiencies Exist

Internal controls are steps implemented by management to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Hawaii Public Employees Health Fund (Health Fund).

We found management to be ineffective in administering the Hawaii Public Employees Health Fund. The serious deficiencies in the financial reporting of the Health Fund's fiscal operations led the certified public accounting firm of Deloitte & Touche LLP to express an opinion that the Health Fund's fiscal 1998 financial statements are not presented fairly in accordance with generally accepted accounting principles. In addition, management's lack of adequate controls to verify certain financial information and monitor the contracts with the insurance carriers resulted in weak accountability of interest income, reserves, and executed agreements. Also, the Health Fund's operating relationship with the executive and legislative branches of the State needs to be improved in order to fulfill its statutory requirements.

Summary of Findings

1. Financial statements are not being prepared in accordance with state law and generally accepted accounting principles. The board of trustees are required to maintain accurate records and accounts of all financial transactions of the Health Fund in accordance with Sections 87-29(2) and (3), Hawaii Revised Statutes (HRS). The Health Fund is following the accounting principles established for governmental-type activities whereas it should be following the accounting principles established for business-type activities. Not following the appropriate accounting principles results in an inaccurate reporting of the Health Fund's assets, liabilities, revenues, and expenses. Approximately $294 million of revenues and $203 million of expenses were not reported by the Health Fund.

2. A lack of clarity between the Health Fund and its insurance carriers as to the definition and measurement of rate stabilization reserves has resulted in substantial excess reserves. State law allows the insurance carriers to hold reserves in order to stabilize health benefits plan premium rates. Any amount in excess of such rate stabilization reserves is required to be returned to the State and counties. Because the definition and measurement of reserves lacks clarity, the Health Fund has allowed the insurance carriers to hold substantial reserves in excess of the amount required to stabilize future premium rates. In

addition, an insurance carrier that benefited from holding reserves was required to pay only the Health Fund's 5 percent interest on these reserves. The rate was negotiated by the board of trustees for the benefit of the Health Fund members. However, the low negotiated rate and substantial excess reserves resulted in the State and counties not having access to millions of dollars that belonged to them.

3. The interest income earned on the reserves held by the insurance carriers is not being monitored. With one exception, the Health Fund has no agreements with the insurance carriers that specify the interest rates to be used or any reporting requirements. Accordingly, the Health Fund is unable to determine whether the insurance carriers are reporting the proper amounts of interest.

4. The agreements with the insurance carriers to provide health care benefits that were in effect during the 1998 fiscal year have not been signed (with the exception of the carrier providing life insurance benefits and one carrier providing dental benefits). Without signed agreements, the Health Fund may face difficulties in trying to enforce certain provisions of the agreements.

5. The Health Fund has not been able to implement a long-term care insurance benefit plan, as required by law, nor has it been able to return excess premiums to employees because it has not obtained approval from the executive and legislative branches of the State to do so. Funding requests to implement a long-term care plan have been denied. Legislative bills that would authorize cash refunds of excess premiums to employees have failed to pass. Accordingly, the Health Fund has not been able to carry out two of its mandated functions.

Management's Ineffective Administration of the Health Fund Results in Serious Problems

The Hawaii Public Employees Health Fund (Health Fund) is controlled by a nine-member board of trustees (Board) which administers and carries out the purpose of this fund. The Board has appointed an administrator and staff to fulfill its requirements and state laws.

The Board and the administrator are tasked with managing the Health Fund; however, they are ineffective in meeting statutory financial reporting standards, defining and controlling rate stabilization reserves, monitoring and executing insurance carrier agreements, and implementing a statutorily required long-term care insurance benefit plan. Heavy reliance on consultants may contribute to the difficulties of meeting these requirements.

Financial reporting violates state law and fails to comply with accounting standards

Sections 87-29(2) and (3), HRS, require the Board of the Health Fund to maintain suitable and adequate records for the fund's operations and accurate records and accounts for all financial transactions. However, the fund's accounting records are so deficient that these statutory requirements are being violated.

In addition, the fund's financial statements should follow standards that make them accurate, consistent, and readable by many users. The Health Fund prepares annual financial reports that are read by state and county employers, active and retired employees and their beneficiaries, insurance carriers, and legislative bodies. Therefore, its reports should be prepared accurately and in accordance with proper accounting standards. This was not done.

The Health Fund's failure to follow the proper accounting and financial reporting standards was serious enough to warrant an adverse opinion from the certified public accounting (CPA) firm of Deloitte & Touche LLP on the Health Fund's June 30, 1998 financial statements. An adverse opinion, the worst possible opinion that is issued by CPA firms, concludes that the financial statements are not presented fairly in accordance with generally accepted accounting principles. Only in extreme and rare cases is an adverse opinion given, which magnifies the Health Fund's reporting deficiencies. Failure to comply with the proper accounting and reporting standards violates Sections 87-29(2) and (3), HRS, and places the State at risk when trying to determine the true financial condition of and cost to operate the Health Fund.

The Governmental Accounting Standards Board of the Financial Accounting Foundation (GASB) issues accounting and financial reporting standards for governmental entities. The GASB has issued standards specifically for agencies called *public entity risk pools*. A public entity risk pool is defined as a cooperative group of governmental entities joining together to finance a risk, such as employee health care. The Health Fund meets this definition and, accordingly, is considered to be a public entity risk pool.

Governmental entities use different fund types to account for their governmental-type and business-type activities. The GASB requires all public entity risk pools to account for their activities in a business-type fund, called an enterprise fund. However, instead of business-type funds, the Health Fund incorrectly uses the governmental-type general, expendable trust, and agency funds. This means that the public does not get an accurate picture of the Health Fund's financial activities. Because the Health Fund is using the wrong accounting principles, it is inaccurately reporting financial transactions that impact its assets, liabilities, revenues and expenses. For example, under accounting standards applicable to enterprise funds, the Health Fund should be reporting the premiums collected from the State, counties and employees as revenues, and its payments to the insurance carriers as expenses. Had the Health Fund followed the proper accounting standards, it would have recorded revenues of approximately $294 million and expenses of approximately $203 million for the year ended June 30, 1998. Failure to record these revenues and expenses results in a significant reporting weakness that is misleading to all users.

In addition, generally accepted accounting principles require that the underwriting gains and interest income, which are held by insurance carriers and used to offset future underwriting losses during the contract period, not be recorded as assets until the expiration of the contract period. The Health Fund incorrectly recorded $17.4 million in underwriting gains, as well as $2.1 million of related interest income, as assets as of June 30, 1998.

The measurement focus and basis of accounting are substantially different for business-type (e.g., an enterprise fund) and governmental-type funds. For example, the measurement focus of a business-type fund is on the flow of economic resources ("Is the fund better or worse off economically as a result of this transaction?"); whereas the measurement focus of a governmental-type fund is on the flow of current financial resources ("Are there greater or fewer resources that can be spent in the future as a result of this transaction?") In addition, the basis of accounting of a business-type fund utilizes a full accrual basis, whereas a governmental-type fund uses a modified accrual basis. The full accrual basis records revenue when earned; the modified accrual basis records revenue when measurable and available for use.

We believe that the Health Fund's failure to follow proper accounting and financial reporting standards is caused in part by the Board's and the administrator's lack of direction and training of accounting staff in current, relevant accounting standards. The GASB standard for public entity risk pools was issued almost ten years ago, in November 1989, and became effective for fiscal periods beginning after June 1993. However, the Health Fund's current accounting and financial reporting policies have not changed substantially since the mid-1980s; therefore, it has been deficient in complying with state law and accounting standards for almost six years.

Recommendation

We recommend that management comply with state law and account for and report the Health Fund's financial activities as required by generally accepted accounting principles. In addition, management should ensure that the accounting staff improve their knowledge of generally accepted accounting principles applicable to the Health Fund.

Management's failure to define reserves and establish adequate interest rate earnings in insurance carrier agreements could prove costly to the State

Act 276, Session Laws of Hawaii (SLH) 1997, amended Section 87-3, HRS, to allow the Health Fund to use rate credits or reimbursements from insurance carriers to stabilize health benefit plan premium rates. Any amount in excess of such rate stabilization reserves is required to be returned to the State and counties.

We found that there is confusion among the Health Fund's management and the insurance carriers regarding the definition and measurement of the rate stabilization reserves; as a result, insurance carriers retain millions of dollars of excess reserves that rightfully belong to the State, counties, and employees.

Act 276 did not include a definition of what constitutes a rate stabilization reserve, and the Health Fund does not have a document defining such a reserve. Also, the Health Fund's contracts with the insurance carriers vary in how reserves are defined and handled. We found that only the contracts for the medical plans with Hawaii Medical Service Association (HMSA) identify a dollar amount for reserves. For active employees, the reserves were $7,460,494 for FY1997-98 and $10,367,771 for FY1998-99. For retired employees, the reserves for FY1997-98 and FY1998-99 are $8,458,520.

None of the other insurance contracts specify an amount for rate stabilization reserves. This inconsistency and lack of definition for rate stabilization reserves allowed HMSA to retain reserves for its benefit. For example, the Health Fund's agreement with HMSA provides for 5 percent interest earnings on the reserves held by HMSA to be credited to the Health Fund. However, during the period of HMSA's contract, indexes for equity investments (stocks)—such as the Standard and Poor's (S&P) 500—reported an average return on investments of over 28.2 percent per year from 1996 - 1998. This index is used in the investment industry to measure the average return on an investment in 500 selected companies in the nation and is a good measure or standard of what an investor could expect to receive in a given time period. This index is 23.2 percent higher than what HMSA is crediting to the Health Fund.

If HMSA invested the State's rate stabilization reserves in the S&P 500 companies, it could have earned approximately $19 million in one year ($81 million in reserves multiplied by 23.2 percent), which would have benefited only HMSA and not the Health Fund. Clearly, the rate of 5 percent negotiated by the Board is extremely low and raises questions as to the Board's effectiveness in establishing rates in the best interest of the Health Fund.

Furthermore, the unclear definition of a rate stabilization reserve allowed the insurance carriers to keep underwriting gains as rate stabilization reserves. Underwriting gains are those that result from an insurance carrier collecting more premiums than it pays out in claims and expenses.

Underwriting losses occur when claims and expenses exceed the amount of premiums collected. Most of the Health Fund's contracts with insurance carriers allow an underwriting loss during a contract period (usually two or three years) to be offset against an underwriting gain from another year, as well as against the rate stabilization reserve plus accrued interest. At the end of the contract period, all net underwriting gains, stabilization reserves, and accrued interest remaining must be returned to the Health Fund. Any net underwriting loss is absorbed by the insurance carriers.

Although insurance carriers are contractually required to return all net underwriting gains, stabilization reserves, and accrued interest at the end of a contract period, the Health Fund has allowed the insurance carriers to retain such funds. In addition, in 1996, the Health Fund further violated this statutory requirement by transferring $38 million of its investment funds to the insurance carriers. We were informed that these transfers were made to enable the fund to earn a higher rate of return. By the end of FY1997-98, the deposits with insurance carriers had grown to approximately $86 million. Of this amount, approximately $81 million was held by HMSA under its medical and prescription drug plans. The next largest amount was approximately $3 million held by Hawaii Dental Service under its dental plans.

Act 141, SLH 1998, sought to remedy this situation by requiring excess reserves to be returned to the State and counties effective July 1, 1998. Management requested each insurance carrier to determine the amount of excess reserves being held, and a total of $43.4 million was identified by the insurance carriers. While this amount is substantial, a previously agreed-upon determination of a rate stabilization reserve by the Health Fund's management and the insurance carriers may have resulted in a higher amount. It could also be argued that the one-year growth in reserves of approximately $18 million in FY1997-98 should be considered excess reserves and also returned to the Health Fund.

Management contracted with a national actuarial and employee benefits consulting company to assist the Health Fund in establishing operating requirements and contracting with the insurance carriers. Even with assistance from the consultant, management failed to define a rate stabilization reserve, enforce a contract provision requiring the insurance carriers to return excess reserves, or negotiate an adequate interest rate on reserves. These deficiencies caused the State and counties the loss of the use of millions of dollars. The magnitude of the reserves kept by HMSA and the extremely low rate of interest negotiated by management raises serious concerns about management's prudent oversight of the fund's resources.

Recommendation

We recommend that management clarify the definition of a rate stabilization reserve, enforce the provisions of the contracts with the insurance carriers which require the return of excess reserves to the State, and negotiate adequate interest rate earnings on reserves to the Health Fund.

Controls over the monitoring of interest income are weak

The Health Fund's contracts with insurance carriers stipulate that the carriers must pay interest on the funds they hold. However, because management does not request supporting documents verifying interest earnings and other financial information from certain carriers, the Health Fund is not able to monitor the amount of interest income that is being earned and reported by the carriers. The annual interest earned amounts to millions of dollars, since the Health Fund allowed the insurance carriers to hold $86 million of the fund's reserves at June 30, 1998. The lack of control procedures to verify interest earnings raises serious concerns over management's accountability for all revenues, not just interest earnings. Accountability for all revenues is essential to protecting the Health Fund's assets.

Except for the medical contracts with HMSA, contracts with the insurance carriers lack a specification of the rates used to accrue interest on the amount of funds held. Since no minimum interest rate is stated in most contracts, insurance carriers may not be maximizing their efforts to attain a reasonable rate of return. If such is the case, the Health Fund has no recourse against the insurance carriers.

In addition, the Health Fund has not required insurance carriers to report interest earnings on reserves held or to verify them with investment statements. While most of the carriers provide the Health Fund with monthly reports of amounts they hold, only a few of the carriers report the interest earnings on these amounts. To determine the amount of interest earned, the Health Fund relies on annual confirmation letters sent by the Health Fund's independent auditors to the insurance carriers.

The carriers reported a total of $2.5 million of interest income for FY1997-98. If this is accurate, then 2.9 percent is the approximate interest earnings rate on the over $86 million held by the insurance carriers. Because of a lack of oversight and contract management, the Health Fund is unable to determine whether this amount is the actual amount that should have been reported, or whether the rate of return is reasonable.

Recommendation

We recommend that during the next contract renewal period, management negotiate the minimum interest rates to be earned by the insurance carriers. In addition, the Health Fund should require the carriers to provide a quarterly report on the interest earned and the reserve amounts held. The Health Fund could then determine the accuracy of interest earnings reported by insurance carriers.

Management is operating with unsigned insurance carrier contracts

Section 87-22, HRS, allows the Board to contract for certain health benefit plans. The Health Fund has contracts with various insurance carriers to provide health care and life insurance benefits. Exhibit 2.1 lists the Health Fund's signed and unsigned insurance carrier contracts.

Exhibit 2.1
Listing of Signed and Unsigned Insurance Carrier Contracts, June 30, 1998

	Insurance Carrier and Plan	Contract: Signed or Unsigned
1.	Hawaii Medical Service Association: Medical – Active employees	Unsigned
2.	Hawaii Medical Service Association: Medical – Retired employees	Unsigned
3.	Kaiser: Medical and Drug – Active and retired employees	Unsigned
4.	Kapiolani Health Hawaii: Medical – Active and retired employees	Unsigned
5.	Hawaii Medical Service Association: Prescription Drug – Active employees	Unsigned
6.	Hawaii Medical Service Association: Prescription Drug – Retired employees	Unsigned
7.	Vision Service Plan: Vision Care – Active employees	Unsigned
8.	Vision Service Plan: Vision Care – Retired employees	Unsigned
9.	Hawaii Dental Service: Adult Dental Care – Active employees	Unsigned
10.	Hawaii Dental Service: Adult Dental Care – Retired employees	Unsigned
11.	Hawaii Dental Service: Children's Dental Care – Dependents of active and retired employees	Unsigned
12.	DentiCare: Adult and Children's Dental Care – Active and retired employees and their dependents	Signed
13.	Grand Pacific Life Insurance Company: Life insurance – Active and retired employees	Signed

All of the contracts identified in Exhibit 2.1 should be effective from July 1, 1996 through June 30, 1999. However, as of June 30, 1998, with the exception of Grand Pacific Life Insurance Company and DentiCare, none of the contracts were properly executed by the Health Fund.

According to the Health Fund, its deputy attorney general did not approve signing the contracts. Nevertheless, the deputy attorney general declined to provide us with a written confirmation that the contracts were valid and enforceable.

Since management is required to protect the interest of the fund and members served, its failure to properly execute the contracts not only means the enforcement of contract provisions is unlikely but also that both the Health Fund and the State are at risk if contractual disagreements arise.

Among the more sensitive contract provisions are those relating to premium amounts, retention percentages for administrative expenses, measurement of reserves for claims incurred but not reported, terms of measurement of gains and losses, application of surplus funds, and contract extension periods. Disagreements about any of these provisions could seriously jeopardize the operations of the Health Fund and could result in additional costs being incurred.

Recommendation

We recommend that management ensure that contracts with insurance carriers are timely and properly executed.

Failure to Meet Statutory Requirements Has Negatively Impacted Members' Benefits

Because the Health Fund was created by state law and is administratively attached to the Department of Budget and Finance, many of its major undertakings require approval beyond that of its Board (i.e., at the executive or legislative branch level). We found that management's inability to obtain such approvals hampers carrying out two of its major functions.

A long-term care insurance benefit plan has not been implemented

Act 334, SLH 1989, authorized the Health Fund to implement and administer a long-term care insurance benefit plan for the State and county employee-beneficiaries and their dependents. However, such a plan is still non-existent.

Long-term care is what people who can no longer care for themselves require. Such people need help performing many activities of daily living including eating, bathing, and dressing. Long-term care can be given in a wide range of settings, from private homes to residential nursing facilities.

Long-term care insurance can be a viable means of meeting the often high cost of long-term care because Medicare generally covers very few of these expenses and Medicaid is available only after a patient's personal resources have been exhausted.

In 1991, the Health Fund contracted with a consultant to report on the issues and provide recommendations related to establishing a long-term care insurance plan. However, eight years after the study, management has not been able to obtain approval to adopt such a plan or to follow up on the study. Management submitted budget requests for the 1991-93, 1993-95, and 1995-97 biennium periods, but these funding requests were denied.

We understand that a long-term care plan can be established with only employee contributions. Third-party administrators could assess fees to the plan out of interest earnings from employee contributions; therefore, initial state appropriations may not be needed to implement a plan.

Although the Legislature approved the expenditure of $150,000 of Health Fund moneys for an actuarial study on long-term care, during the 1998 legislative session it denied the Health Fund's request to expend $103,000 for the implementation of a long-term care insurance plan. Management believes that the legislatively approved study benefits all state residents, not only Health Fund beneficiaries. Accordingly, management does not believe that this is a proper expenditure of its funds and has sought the advice of the Departments of Budget and Finance and the Attorney General. As a result, implementation of a long-term care plan will be further delayed.

Millions of dollars in excess reserves have not been returned to members

The Health Fund is required by Act 276, SLH 1997, to return excess reserves that were paid by the State and the counties. Act 141, SLH 1997, defines the amount to be returned effective as of July 1, 1998. However, the disposition of the excess reserves paid by employees and retirees (approximately $13 million as of June 30, 1998) is unclear. Act 276, SLH 1997, indicates that any excess reserves derived from employee contributions may be used to improve the health benefit plans or to reduce the employees' monthly contributions to a health plan, as in a premium holiday. The act does not specifically address whether or not providing cash refunds to the employees is allowable.

Management does not believe that providing premium holidays to employees is the fairest way to dispose of the excess reserves. This is because many of the employees whose contributions created the excess reserves would not benefit, due to their retirement, resignation, or transfer to a union-sponsored plan.

During the 1998 legislative session, management tried but failed to have a bill passed that would have allowed the Health Fund to provide cash refunds to its current and former employees.

In addition, we were informed that management obtained an opinion from a deputy attorney general in August 1998 that indicates the Health Fund cannot provide cash refunds to its employees. However, we were not allowed to read the opinion.

Management has been unable to resolve the disposition of excess reserves applicable to employee contributions since July 1997, more than 18 months ago. Unless management can resolve this matter, the reserves will continue to grow, and employees will receive unequal treatment from employers regarding the refunding of excess reserves.

Recommendation

We recommend that management work more closely with the Legislature and the Departments of Budget and Finance and the Attorney General in resolving the issues relating to (a) the adoption of a long-term care insurance benefit plan and (b) the disposition of excess reserves created by employee contributions.

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Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Hawaii Public Employees Health Fund (Health Fund) as of and for the fiscal year ended June 30, 1998. This chapter includes the independent auditors' report and the report on compliance and on internal control over financial reporting based upon the audit performed in accordance with *Government Auditing Standards*. It also displays financial statements together with explanatory notes.

Summary of Findings

Because the Health Fund did not account for its financial activities in an enterprise fund as required by generally accepted accounting principles and because certain gain contingencies have been recorded in the financial statements, in the opinion of Deloitte & Touche LLP, based on their audit, the financial statements do not present fairly the financial position of the Health Fund at June 30, 1998, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Deloitte & Touche LLP considered the Health Fund's failure to account for its activities in the proper fund to be a reportable condition and a material weakness in the internal control system. But, they did not note, with respect to the items tested, any instance of noncompliance with laws and regulations applicable to the Health Fund that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

To the Auditor
State of Hawaii

We have audited the following financial statements of the Hawaii Public Employees Health Fund (Health Fund):

- Combined Balance Sheet – All Fund Types and Account Groups – June 30, 1998 (Exhibit A);

- Combined Statement of Revenues, Expenditures and Changes in Fund Equity – General and Expendable Trust Funds – fiscal year ended June 30, 1998 (Exhibit B);

- Combined Statement of Revenues and Expenditures – Budget and Actual – General Fund – fiscal year ended June 30, 1998 (Exhibit C);

- Statement of Changes in Assets and Liabilities – Agency Fund – fiscal year ended June 30, 1998 (Exhibit D).

These financial statements are the responsibility of the management of the Health Fund. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following two paragraphs, we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In accordance with the terms of our engagement, the scope of our audit did not include the general fixed assets account group, which reflected total assets of $387,939 as of June 30, 1998.

Management of the Health Fund declined to provide us with a written representation letter which, among other things, acknowledges its responsibility for the fair presentation of the financial statements in accordance with generally accepted accounting principles. Generally accepted auditing standards require us to obtain such management representation letter.

As discussed in the notes to the financial statements, the financial statements referred to above present only the activities of the Health Fund and are not intended to present fairly the financial position and results of operations of the State of Hawaii, in conformity with generally accepted accounting principles.

The financial statements referred to above account for the financial activities of the Health Fund in a governmental fund, i.e., general fund, and in fiduciary funds, i.e., trust and agency funds. However, in our opinion, the Health Fund is considered to be a public entity risk pool, and thus its financial activities should be accounted for in a proprietary fund, i.e., enterprise fund, in order to conform with generally accepted accounting principles.

In addition, the financial statements referred to above include net underwriting gains of $17,400,084 and interest income of $2,096,938 that are recorded in the deposit with insurance carriers account, with the offsetting credits being recorded as other financing sources of $14,383,869, and beginning fund balance of $5,113,153. In our opinion, such amounts are considered to be gain contingencies, since they can be offset by underwriting losses incurred in the fiscal year ending June 30, 1999, the last year of the contract period with the insurance carriers. Accordingly, such amounts should not be recorded in the financial statements, in order for such financial statements to be in conformity with generally accepted accounting principles.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue in order for financial statements to be prepared in accordance with generally accepted accounting principles. Such required disclosures include:

- Any significant amount of resources committed to make computer systems and other electronic equipment year 2000-compliant;
- A general description of the year 2000 issue, including a description of the stages of work in process or completed as of the end of the reporting period to make computer systems and other electronic equipment critical to conducting operations year 2000-compliant; and
- The additional stages of work necessary for making the computer systems and other electronic equipment year 2000-compliant.

The Health Fund has omitted such disclosures. We do not provide assurance that the Health Fund is or will be year 2000 ready, that the Health Fund's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Health Fund does business will be year 2000 ready.

In our opinion, because of the effects of the matters discussed in the three preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of the Health Fund as of June 30, 1998, or the results of its operations for the year then ended.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 24, 1998, on our consideration of the Health Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
December 24, 1998

Independent Auditors' Report on Compliance and on Internal Control over Financial Reporting Based upon the Audit Performed in Accordance with *Government Auditing Standards*

To the Auditor
State of Hawaii

We have audited the financial statements of the Hawaii Public Employees Health Fund (Health Fund) as of and for the year ended June 30, 1998, and have issued our report thereon dated December 24, 1998, which included an adverse opinion resulting from the Health Fund: (1) not accounting for financial activities in a proprietary fund, (2) recording gain contingencies, and (3) omitting the year 2000 disclosures that are required by Government Auditing Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, except that management of the Health Fund declined to provide us with a written representation letter, which is required under generally accepted auditing standards, and that the scope of our audit did not include the general fixed assets account group.

Compliance

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

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Health Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Health Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is as follows:

The Health Fund is incorrectly reporting its financial activities in governmental and fiduciary funds rather than in an enterprise fund as required by generally accepted accounting principles. This results from the accounting staff's inability to keep current on relevant accounting standards.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is a material weakness.

This report is intended solely for the information and use of the Auditor, State of Hawaii, the management and directors of the

Health Fund, the Governor, and the Legislature of the State of Hawaii and is not intended to be and should not be used by anyone other than these specified parties.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
December 24, 1998

Descriptions of Financial Statements

The following is a brief description of the financial statements which are attached to the end of this chapter.

Combined Balance Sheet - All Fund Types and Account Groups (Exhibit A). This statement presents assets, liabilities and fund equity of all fund types and account groups used by the Health Fund on an aggregate basis at June 30, 1998.

Combined Statement of Revenues, Expenditures and Changes in Fund Equity - General and Expendable Trust Funds (Exhibit B). This statement presents the revenues, expenditures and changes in fund equity for governmental and fiduciary fund types used by the Health Fund on an aggregate basis for the year ended June 30, 1998. Revenues include State appropriations mandated by various appropriation acts of the State Legislature.

Combined Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis) - General Fund (Exhibit C). This statement summarizes revenues and expenditures by source and type on the budgetary basis for the Health Fund for the year ended June 30, 1998, and compares such amounts to the budget as adopted by the State Legislature.

Statement of Changes in Assets and Liabilities - Agency Fund (Exhibit D). This statement presents the changes in assets and liabilities of the Agency Fund for the Health Fund for the year ended June 30, 1998.

Notes to the Combined Financial Statements

Explanatory notes, which are pertinent to an understanding of the financial statements and financial condition of the funds included in the scope of the audit, are discussed in this section.

Note 1 - Financial Reporting Entity

The Hawaii Public Employees Health Fund (Health Fund), which is administered by a nine-member Board of Trustees appointed by the Governor, was established under Chapter 87 of the Hawaii Revised Statutes (HRS) to provide medical, dental, prescription drug, vision care, and life insurance benefits for the State of Hawaii's (State) and the counties' active and retired employees and their dependents.

The Board of Trustees of the Health Fund (Board) determines the scope of the various benefit plans and contracts with insurance carriers to provide health and group life insurance benefit coverages.

Summary information on the Health Fund's plans is described below:

> ***Benefit plans*** - The medical plans include a statewide service benefit plan, a statewide health maintenance organization (HMO) plan, and a federally-qualified HMO plan. Other benefit plans (dental, prescription drug, vision care and group life insurance) are offered on a statewide basis.
>
> ***Payment of contributions*** - The employers' share of benefit plan contributions for collectively bargained employees are negotiated by the State and counties with the exclusive representative of each employee bargaining unit. Employer contributions for all other employees not covered by collective bargaining contracts and for employees who retire after June 30, 1984, with less than ten years of service, are prescribed by the HRS. Any remaining premium balance is paid by employees through payroll deductions or Premium Conversion Plan reductions.
>
> State and county contributions also include the employee's share for retired employees and Medicare reimbursements made by the Health Fund to eligible retired employees and their spouses for Medicare Part B insurance premiums withheld from their social security benefits.

As of June 30, 1998, the Health Fund provided insurance coverage to approximately 145,000 individuals: 59,000 active employees; 29,000 retirees; 25,000 spouses; and 32,000 dependents under age 19.

Note 2 - Summary of significant accounting policies

Reporting entity

The Health Fund is a division of the Department of Budget and Finance in the executive branch of the State. The Health Fund's combined financial statements reflect only its portion of the fund type categories. The State Comptroller maintains the central accounts for all state funds and publishes annual financial statements for the State which includes the Health Fund's financial activities.

Basis of presentation

The accounts of the Health Fund are organized on the basis of funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures. Governmental resources are allocated to and accounted for in individual funds based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

Amounts in the "Total (Memorandum Only)" columns in the combined financial statements represent summations of the financial statement line items of the fund types and account groups included in those statements, and are presented only for analytical purposes. Those summations may include fund types and account groups that use different bases of accounting. Consequently, amounts shown in the "Total (Memorandum Only)" columns are not comparable to a consolidation and do not represent the total resources available or total revenues and expenditures of the Health Fund.

For financial reporting purposes, the Health Fund includes all funds and account groups that are controlled by or dependent on the Health Fund's administrative head. Control by or dependence on the Health Fund was determined on the basis of statutory authority and moneys flowing through the Health Fund to each fund or account.

The Health Fund uses the following fund types and account groups:

Governmental fund types

General Fund: The general fund is the general operating fund of the Health Fund. It is used to account for all financial activities except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted.

Fiduciary fund types

Trust and Agency Funds: Trust and agency funds are used to account for assets held by the Health Fund in a trustee or agency capacity. These include expendable trust funds which account for cash collected and expended by the Health Fund as trustee and agency funds which account for the receipts and disbursements of various amounts collected by the Health Fund in a custodial capacity.

Account groups

General Fixed Assets Account Group: General fixed assets acquired for use by the Health Fund in the conduct of its general governmental operations are accounted for in the general fixed assets account group at cost or estimated fair market value at date of donation. Accumulated depreciation is not recorded in the general fixed assets account group.

General Long-Term Debt Account Group: The obligation for accrued vested vacations is recorded in the general long-term debt account group.

Basis of accounting

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds and expendable trust funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities are generally included on the combined balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The Health Fund uses the modified accrual basis of accounting for the general, expendable trust, and agency funds. Under the modified accrual basis of accounting, revenues and related current assets are recognized in the accounting period when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at fiscal year-end. Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year end to liquidate liabilities existing at the end of the fiscal year. Revenues susceptible to accrual include funds appropriated by the State Legislature and allotted by the Governor.

Use of estimates

The preparation of combined financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and short-term investments

Cash and short-term investments include all demand deposits, time certificates of deposit and repurchase agreements purchased with an original maturity of three months or less.

Appropriations

An authorization granted by the State Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year.

Encumbrances

Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of moneys are recorded in order to reserve that portion of the applicable appropriation, is employed as an extension of formal budgetary integration in the governmental fund type. Encumbrances outstanding at fiscal year-end are reported as reservations of fund balances since they do not constitute expenditures or liabilities.

Accumulated vacation and sick leave

Employees' vested annual vacation and sick leave are recorded as expenditures when actually taken. The employees of the Health Fund are entitled to receive cash payment for accumulated vacation leave upon termination. The liability for such accumulated vacation leave pay is not reflected in the governmental fund, but is reflected in the general long-term debt account group.

Total columns on the combined financial statements

The total columns are captioned Memorandum Only to indicate that they are presented only to facilitate financial analysis. Data in those columns do not present financial position or results of operations in conformity with generally accepted accounting principles. Neither is such data comparable to a consolidation. Interfund eliminations have not been made in the aggregation of this data.

Note 3 - Budgeting and Budgetary Control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues in the Combined Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis) - General Fund are those estimates as compiled by the Health Fund. Budgeted expenditures are derived primarily from acts of the State Legislature and other specific appropriation acts in various Session Laws of Hawaii.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations.

Summarization of the budget adopted by the State Legislature for the “budgetary” general fund is presented in the Combined Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis) - General Fund. For purposes of budgeting, the Health Fund’s budgetary fund structure and accounting principles differ from those utilized to present the combined financial statements in conformity with generally accepted accounting principles (GAAP). The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP for the fiscal year ended June 30, 1998:

	General Fund
Excess of revenues over expenditures – actual on a budgetary basis	$9,718
Over-encumbered balance	(18,540)
Expenditures for liquidation of prior fiscal year encumbrances	(2,709)
Lapsed restrictions	54,940
Excess of revenues over expenditures – GAAP basis	$43,409

Note 4 - Cash and Short-Term Investments

The State Department of Budget and Finance is responsible for the safekeeping of the cash deposits and short-term investments of the Health Fund. The Health Fund’s cash and short-term investments at June 30, 1998, include all demand deposits, time certificates of deposit and repurchase agreements purchased with an original maturity of three months or less. Cash and short-term investments totaling $4,212,992 at June 30, 1998, are insured or collateralized with securities held by the State Treasury or by the State’s fiscal agent in the name of the State.

Note 5 - General Fixed Assets

The changes in the general fixed assets (unaudited) were as follows:

	Office Furniture and Equipment
Balance at July 1, 1997	$297,392
Additions	104,257
Deductions	(13,710)
Balance at June 30, 1998	$387,939

Note 6 - General Long-Term Debt

The general long-term debt account group is used to account for the long-term portion of the obligation for accrued vested vacations. The obligation changed during the fiscal year ended June 30, 1998, as follows:

	Accrued Vacation Payable
Balance at July 1, 1997	$128,350
Net decrease	(14,228)
Balance at June 30, 1998	$114,122

Note 7 - Non-Imposed Employee Fringe Benefits

Payroll fringe benefit costs of the Health Fund's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the Health Fund's operating funds. These costs, totaling approximately $174,000 for the fiscal year ended June 30, 1998, were reported as revenues and expenditures of the Health Fund's general fund.

Note 8 - Health and Life Insurance Benefit Contracts

The Health Fund's primary purpose, as mandated by HRS Section 87-3, is to provide employee-beneficiaries and dependent-beneficiaries with a health benefits plan and a long-term care benefits plan. To effectuate that purpose, the Health Fund has entered into the following health and life insurance benefit contracts.

Medical benefits

The Health Fund entered into contracts with the Hawaii Medical Service Association (HMSA) to provide active employees and retirees with medical benefits for the period July 1, 1996 through June 30, 1999. Total reserves of $78 million are held by HMSA or its agent in order to stabilize future premium rates and for other purposes. At the end of the contracts, any residual surplus held by HMSA will be refunded to the Health Fund. Moneys held by HMSA's agent are in a trust account that includes, but is not limited to, investments in U.S. government securities. All income earned on these investments is held in trust for the benefit of the Health Fund. Of the $78 million total held by HMSA and its agent, approximately $21 million from Actives Reserves and $21 million from Retiree Reserves are payable to the employers.

During the plan year ended June 30, 1998, HMSA had the following financial experience in premium reserves related to the medical plans provided to the Health Fund:

	Active Employees	Retirees	Total
Medical Plans			
Reserves including interest held by HMSA at June 30, 1997	$7,749,398	$4,956,000	$12,705,398
Interest earned on reserves	418,350	247,055	665,405
Reserves including interest held by HMSA at June 30, 1998	$8,167,748	$5,203,055	$13,370,803
Reserves including interest held by HMSA's agent in a trust account at June 30, 1997	$34,517,114	$15,203,758	$49,720,872
Underwriting gain for plan year ended June 30, 1998	3,410,368	9,190,070	12,600,438
Interest earned on deposits held in trust	861,359	781,929	1,643,288
Reserves including interest held by HMSA's agent in a trust account at June 30, 1998	$38,788,841	$25,175,757	$63,964,598

Health Maintenance Organization Benefits

The Health Fund has also entered into contracts with HMSA to provide active employees and retirees with health maintenance organization (HMO) benefits. During the plan year ended June 30, 1998, HMSA had the following financial experience in the HMO plan:

	Active Employees	Retirees	Total
Reserves including interest held by HMSA's agent in a trust account at June 30, 1997	$153,294	$225,210	$378,504
Interest earned on deposits held in trust	3,738	12,978	16,716
Reserves including interest held by HMSA's agent in a trust account at June 30, 1998	$157,032	$238,188	$395,220
Total held by HMSA and its agents	$47,113,621	$30,617,000	$77,730,621

The Health Fund has recorded the underwriting gains as increases in premium reserves in the accompanying combined financial statements.

Prescription Drug Benefits

The Health Fund entered into contracts with HMSA to provide active employees and retirees with prescription drug benefits for the period July 1, 1997 through June 30, 1999. At the end of each plan year of the prescription drug plan contracts, any residual surplus will be refunded to the Health Fund without interest. As of June 30, 1998, $2.8 million in reserves were being held by HMSA's agent in a trust account that includes investments in U.S. government securities. All income earned on those investments is held in trust for the benefit of the Health Fund. Of the $2.8 million total held by HMSA's agent, approximately $1.7 million from Actives Reserves are payable to the employers. During the plan year ended June 30, 1998, HMSA had the following financial experience in premium reserves related to the prescription drug plans provided to the Health Fund:

	Active Employees	Retirees	Total
Reserves including interest held by HMSA's agent in a trust account at June 30, 1997	$2,750,097		$2,750,097
Underwriting loss for plan year ended June 30, 1998	(1,937,797)	$(3,586,032)	(5,523,829)
Loss carried forward to subsequent plan year or absorbed by HMSA	1,937,797	3,586,032	5,523,829
Interest earned on deposits held in trust	69,133	16,223	85,356
Amount recoverable by HMSA	—	(16,223)	(16,223)
Reserves including interest held by HMSA's agent in a trust account at June 30, 1998	$2,819,230	$ —	$2,819,230

Vision care benefits

The Health Fund contracted with Vision Service Plan (VSP) to provide vision care benefits for active employees and retirees for the period July 1, 1997 through June 30, 1999. During the plan year ended June 30, 1998, VSP had the following financial experience in premium reserves related to the vision care plan it provided to active employees and retirees of the Health Fund:

	Active Employees	Retirees	Total
Premium surplus reserves as of June 30, 1997	$54,071	$110,837	$164,908
Underwriting gain for the plan year ended June 30, 1998	48,523	10,394	58,917
Interest earned on reserves	1,497	5,284	6,781
Premium surplus reserves and interest held by VSP at June 30, 1998	$104,091	$126,515	$230,606

Life insurance benefits

The Health Fund contracted with Grand Pacific Life Insurance Company, Ltd. (GPLI) to provide term life insurance benefits to all eligible active employees and retirees for the period July 1, 1992 through June 30, 1999, including contract extensions. At the end of the extended contract period, any net underwriting gain resulting from the excess of premiums over incurred claims and administrative costs will be refunded to the Health Fund. During the plan year ended June 30, 1998, GPLI experienced an underwriting loss of $625,270 on this contract, resulting in a cumulative underwriting loss of $1,441,174 as of June 30, 1998. Should an underwriting gain occur in the subsequent plan years, the cumulative premium reserve deficit as of June 30, 1998 may be used by GPLI to offset any underwriting gains.

In addition, GPLI holds life insurance reserve funds totaling $529,913 resulting from policy periods July 1, 1983 through June 30, 1992. These reserve funds are available to pay for future supplemental group life and basic policy life insurance benefits and will be reduced as outstanding death claims are paid.

GPLI is also still paying death benefit claims for contracts from July 1, 1973 through June 30, 1983. The basic policy under these contracts included a waiver of the premium payments in the event of total disability while employees were insured under those policies. The waiver of premium reserve funds held by GPLI for these contracts was $1,025,410 as of June 30, 1998.

The Health Fund has recorded the basic and supplemental life insurance reserves and the waiver of premium reserve funds totaling $1,555,323 as part of premium reserve funds on deposit with insurance carriers in the accompanying combined financial statements.

Dental benefits

The Health Fund contracted with Hawaii Dental Service (HDS) to provide separate dental plans for active employees, retirees and children under age 19 for the period July 1, 1993 through June 30, 1999, including contract extensions.

The Health Fund agreed to allow HDS to establish special reserve accounts with negative balances in the amount of $1,000,000 and $600,000, for the active employees' and retirees' plans, respectively. According to these contracts, should an underwriting gain result at the end of the contracts, HDS will retain the underwriting gain amount up to the remaining negative balance in the special reserve account. Any residual underwriting gain in excess of the negative special reserve account balance will be returned to the Health Fund. Should an underwriting loss result at the end of the contracts, HDS will absorb such underwriting loss.

The special reserve accounts with negative balances are not included in the Health Fund's reserve fund balance as of June 30, 1998. The Health Fund agreed to allow HDS to accumulate special reserve funds up to

$200,000 for the children's plan from underwriting gains, if any, during the contract period. As of June 30, 1998, the special reserve account balance for the children's dental plan was zero.

During the plan year ended June 30, 1998, HDS had the following financial experience in premium reserves related to the adults' and children's dental plans it provided to the Health Fund:

	Adult's Dental Plan		
	Active Employees	Retirees	Children's Dental Plan
Reserve balance as of June 30, 1997	$940,298	$1,923,370	
Underwriting gain (loss) for the plan year ended June 30, 1998	937,189	(412,145)	$(290,495)
Loss absorbed by HDS			290,495
Interest earned	32,310	16,347	
Additional surplus reserves held by HDS at June 30, 1998	$1,909,797	$1,527,572	$ —

Note 9 - Retirement Benefits

Employee Retirement System

All full-time employees of the Health Fund are eligible to participate in the Employee Retirement System of the State of Hawaii (ERS), a cost sharing, multiple-employer public employee retirement system covering eligible employees of the State and counties.

The ERS is composed of a contributory retirement plan and a noncontributory retirement plan. Eligible employees who are in service and a member of the existing contributory plan on June 30, 1984, were given an option to remain in the existing plan or join the noncontributory plan, effective January 1, 1985. All new eligible employees hired after June 30, 1984, automatically become members of the noncontributory plan. Both plans provide death and disability benefits and cost of living increases. Benefits are established by state statute. In the contributory plan, employees may elect normal retirement at age 55 with 5 years of credited service or elect early retirement at any age with 25 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 2% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching five years of service; retirement benefits are actuarially reduced for early retirement. Covered contributory plan employees are required by State statute to contribute 7.8% of their salary to the plan. In the noncontributory plan, employees may elect normal retirement at age 62 with 10 years of credited service or at age 55 with 30 years of credited service, or elect early retirement at age 55 with 20 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 1.25% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching ten years of service; retirement benefits are actuarially reduced for early retirement.

Information on actual contributions to the ERS is not available on a departmental basis.

The ERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to the Employee Retirement System, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813-2929 or by calling (808) 586-1660.

Post-retirement health care and life insurance benefits

In addition to providing pension benefits, the Hawaii Public Employees Health Fund (Health Fund) provides certain health care (medical, prescription drug, vision and dental) and life insurance benefits for the State's retired employees. Contributions are based upon negotiated collective bargaining agreements and are limited by state statute to the actual cost of benefit coverage. The State pays for 100% of these benefits for employees who have at least 10 years of service. The State's share of the cost of these benefits is pro-rated for employees with less than 10 years of service. The State also reimburses Medicare expenses of retirees and qualified spouses (through the State of Hawaii) who are at least 62 years of age and have at least 10 years of service. Currently, approximately 21,000 retirees and surviving spouses are receiving post retirement health care (including Medicare) and life insurance benefits paid for by the State. The Health Fund's general fund share of the post-retirement benefits expense for the fiscal year ended June 30, 1998 has not been separately computed and is not reflected in the Health Fund's combined financial statements.

Note 10 - Commitments and Contingencies

Accumulated sick leave pay

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit. Sick leave can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 1998, approximated $560,000.

Insurance

Insurance coverage is maintained at the state level. The State is substantially self-insured for all perils including workers' compensation. Expenditures for workers' compensation and other insurance claims are appropriated annually from the state general fund.

The Health Fund is covered by the State's self-insured Workers' Compensation Program for medical expenses of injured employees. However, temporary wage loss replacement benefits to these employees are paid by the Health Fund.

Deferred compensation plan

The State participates in the deferred compensation plan established by the State of Hawaii in accordance with Internal Revenue Code Section 457. The plan is available to all State employees, including component units, and permits employees to defer a portion of their salary until future years by contributing to a fund managed by a plan administrator. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State subject to the claims of the State's general creditors. Participants' rights under the plan are equal to those of general creditors of the State in an amount equal to the fair value of the deferred account for each participant. The State believes that it is unlikely that it will use the assets to satisfy the claims of general creditors in the future.

The plan's assets and corresponding obligations to employees for such deferred compensation amounts, which amounted to $27.7 million at June 30, 1998, are accounted for in an agency fund of the primary government and comprises investments in retirement options (stocks, bonds, savings accounts and money market accounts). At June 30, 1998, the investments were insured or registered or the securities were held by the state's agent in the state's name. Investments are managed by the plan's trustee. Assets and corresponding obligations to employees of the component units do not constitute a separate plan. The plan's assets are stated at fair value.

It is the opinion of the state's legal counsel that the State has no liability for losses under the plan but does have the duty of due care that would be required of an ordinary prudent investor.

Note 11 - Related Party Transactions

All state agencies are required to reimburse the State for contributions made by the State to the Health Fund for employees whose compensation is paid entirely or in part from special revenue or federal funds. All of the counties are also required to reimburse the State for their prorated share of the cost of administering the Health Fund. These reimbursements are deposited directly into the state general fund and are not reflected in the combined financial statements of the Health Fund.

The Health Fund's general fund appropriations included amounts for personal services and other operating expenditures. The State's contribution for medical, dental, life insurance, vision care, and prescription drug benefits is transferred to the Health Fund from the Department of Budget and Finance each month and is accounted for in the agency fund as a deduction of the receivable due from the State.

The Health Fund's office is located in the City Financial Tower. This office space is being leased and paid for by the Department of Accounting and General Services for the use of the Department of Budget and Finance.

Note 12 - Risk Management

The Health Fund is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees.

Torts. The Health Fund is involved in various actions, the outcome of which, in the opinion of management, will not have a material adverse effect on the Health Fund's financial position. Losses, if any, are either covered by insurance or will be paid from legislative appropriations of the state general fund.

Property and Liability Insurance. The State has purchased property damage insurance for losses that may occur for substantially all state facilities, including those of the Health Fund. The policies provide for coverage of $100,000,000 per occurrence with a $250,000 deductible. The deductible for windstorm coverage is 2.5% of loss subject to a $250,000 minimum and $2,500,000 maximum per occurrence. Included in the property damage insurance is flood insurance for coverage up to $50,000,000 with a deductible of 5% of loss subject to the $250,000 minimum deductible. In addition, the State is the owner of a general liability insurance policy with an annual aggregate of $23,000,000 per occurrence, subject to a $2,000,000 deductible. Claims under $10,000 are handled by the risk management office of the Department of Accounting and General Services. Losses not covered by property and liability insurance are paid from legislative appropriations of the general fund.

Workers' Compensation. The State is self-insured for workers' compensation. Expenditures for workers' compensation are appropriated annually from the general fund. The Health Fund is covered by the state's self-insured Workers' Compensation Program for medical expenses of injured employees. However, temporary wage loss replacement benefits to these employees are paid by the Health Fund. Liabilities for workers' compensation claims are established if information indicates that it is probable that liabilities have been incurred as of fiscal year-end and the amounts of those claims are reasonably estimable. Those liabilities include an amount for claims that have been incurred but not reported. In the opinion of management, the Health Fund has adequately reserved for such claims.

Note 13 - General Fund Deficit Balance

The general fund deficit balance at June 30, 1998 was $18,540. The deficit resulted from expenditures being recorded on the accrual basis when incurred, and revenues being recognized only when the funds are measurable and available.

EXHIBIT A

STATE OF HAWAII, HAWAII PUBLIC EMPLOYEES HEALTH FUND

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
JUNE 30, 1998

	Governmental Fund Type	Fiduciary Fund Types		Account Groups		
ASSETS	General	Expendable Trust	Agency	General Fixed Asset (Unaudited)	General Long-Term Debt	Total (Memorandum Only)
Cash and short-term investments (Note 4)	$ 26,015	$ 2,752,671	$1,434,306			$ 4,212,992
Receivables:						
Employee contributions			60,388			60,388
Insurance carriers			7,943			7,943
Accrued interest		4,805				4,805
Prepaid premiums		355,290				355,290
Deposits with insurance carriers (Note 8)		85,773,149				85,773,149
Due from other fund			1,666,515			1,666,515
Office furniture and equipment (Note 5)				$387,939		387,939
Amount to be provided for payment of general long-term debt					$114,122	114,122
TOTAL	$ 26,015	$88,885,915	$3,169,152	$387,939	$114,122	$92,583,143

EXHIBIT A (Continued)

STATE OF HAWAII, HAWAII PUBLIC EMPLOYEES HEALTH FUND

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS (Continued)
JUNE 30, 1998

	Governmental Fund Type	Fiduciary Fund Types		Account Groups		
LIABILITIES, FUND EQUITY, AND OTHER CREDIT	General	Expendable Trust	Agency	General Fixed Asset (Unaudited)	General Long-Term Debt	Total (Memorandum Only)
IABILITIES:						
Vouchers payable	$ 19,997					$ 19,997
Accrued liabilities	24,558					24,558
Refunds payable:						
Employees			$ 243,089			243,089
Governmental agencies		$43,897,155				43,897,155
State of Hawaii			1,160,175			1,160,175
Counties			1,586,337			1,586,337
Due to other fund		,666,515				1,666,515
Contributions collected in advance			79,551			179,551
Accrued vacation payable (Note 6)					$114,122	114,122
Total liabilities	44,555	45,563,670	3,169,152		14,122	48,891,499
FUND EQUITY AND OTHER CREDIT:						
Investment in general fixed assets				$387,939		387,939
Fund balances:						
Deficit (Note 13)	(18,540)					(18,540)
Reserved for amounts held in trust		43,322,245				43,322,245
Total fund equity and other credit	(18,540)	43,322,245		387,939		43,691,644
TOTAL	$ 26,015	$88,885,915	$3,169,152	$387,939	$114,122	$92,583,143

See accompanying notes to combined financial statements.

EXHIBIT B

STATE OF HAWAII, HAWAII PUBLIC EMPLOYEES HEALTH FUND

COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND EQUITY - GENERAL AND EXPENDABLE TRUST FUNDS YEAR ENDED JUNE 30, 1998

	General	Expendable Trust	Total (Memorandum Only)
REVENUES:			
State allotted appropriations	$ 662,767		$ 662,767
Interest income		$ 196,014	196,014
Other	173,508		173,508
Total revenues	836,275	196,014	1,032,289
EXPENDITURES:			
Administrative expenses:			
Personal services	684,151		684,151
Other	108,715	127,582	236,297
Total expenditures	792,866	127,582	920,448
EXCESS OF REVENUES OVER EXPENDITURES	43,409	68,432	11,841
OTHER FINANCING SOURCES (USES):			
Net increase in premium reserve funds		16,132,197	16,132,197
Operating transfers out		(27,150,269)	(27,150,269)
Total other financing sources (uses)		(11,018,072)	(11,018,072)
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER FINANCING USES	43,409	(10,949,640)	(10,906,231)
OTHER CHANGES IN FUND EQUITY - Lapsed appropriations	(65,027)		(65,027)
FUND EQUITY, BEGINNING OF YEAR	3,078	54,271,885	54,274,963
FUND EQUITY, END OF YEAR	$ (18,540)	$ 43,322,245	$ 43,303,705

See accompanying notes to combined financial statements.

EXHIBIT C

STATE OF HAWAII, HAWAII PUBLIC EMPLOYEES HEALTH FUND

COMBINED STATEMENT OF REVENUES AND EXPENDITURES - BUDGET AND ACTUAL (BUDGETARY BASIS) - GENERAL FUND
YEAR ENDED JUNE 30, 1998

	Actual (Budgetary Basis)	Budget	Variance Favorable (Unfavorable)
REVENUES:			
State allotted appropriations	$ 607,827	$ 607,827	$
EXPENDITURES:			
Administrative expenses:			
Personal services	490,485	495,744	5,259
Other	107,624	112,083	4,459
Total expenditures	598,109	607,827	9,718
EXCESS OF REVENUES OVER EXPENDITURES	$ 9,718	$	$ 9,718

See accompanying notes to combined financial statements.

STATE OF HAWAII, HAWAII PUBLIC EMPLOYEES HEALTH FUND

STATEMENT OF CHANGES IN ASSETS AND LIABILITIES - AGENCY FUND
YEAR ENDED JUNE 30, 1998

ASSETS	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
Cash and short-term investments	$1,580,020	$581,706,402	$581,852,116	$1,434,306
Receivables:				
Employee contributions	59,909	831	352	60,388
Insurance carriers		7,943		7,943
Medicare reimbursements		13,722,451	13,722,451	
Due from other fund	2,967,095		1,300,580	1,666,515
TOTAL	$4,607,024	$595,437,627	$596,875,499	$3,169,152

LIABILITIES	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
Refunds payable:				
Employees	$ 260,891	$ 32,311,965	$ 32,329,767	$ 243,089
State of Hawaii	2,188,731	203,190,636	204,219,192	1,160,175
Counties	1,944,030	78,750,955	79,108,648	1,586,337
Contributions collected in advance	186,098		6,547	179,551
Premiums payable to insurance carriers	27,274	281,184,071	281,211,345	
TOTAL	$4,607,024	$595,437,627	$596,875,499	$3,169,152

See accompanying notes to combined financial statements.

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Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Department of Budget and Finance and the Hawaii Public Employees Health Fund on April 16, 1999. A copy of the transmittal letter to the Health Fund is included as Attachment 1. The responses of the Department of Budget and Finance and Hawaii Public Employees Health Fund are included as Attachments 2 and 3, respectively.

The Department of Budget and Finance did not comment on our recommendation but provided rationale as to as to why prior funding requests to implement a long-term care insurance benefit plan were denied. In addition, it provided information on a current legislative request that proposes to implement this insurance benefit plan.

The Health Fund indicates that due to time restraints the board of trustees is unable to fully respond to all of the findings. It notes that the board will continue to evaluate the findings and respond in the future at a public hearing.

With regard to our finding that the Health Fund's financial reporting violates state law and fails to comply with accounting standards, the board believes that although the accounting standards "may be technically correct," reporting of its financial transactions in expendable trust and agency funds presents a better picture of its operations than reporting in an enterprise fund. We disagree. The current financial reporting of the Health Fund does not comply with the accounting standards. These standards enable everyone—employers, employees, other beneficiaries, the public—to compare the performance of such entities as health funds and be able to rely on their financial statements.

The Health Fund concurred with other findings. The fund's management and board indicated that they will continue to evaluate our findings and take corrective action as appropriate.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

April 16, 1999

COPY

Mr. Cenric S.K. Ho, Administrator
Hawaii Public Employees Health Fund
City Financial Tower
201 Merchant Street, Suite 1520
Honolulu, Hawaii 96813

Dear Mr. Ho:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Hawaii Public Employees Health Fund of the State of Hawaii*. We ask that you telephone us by Monday, April 19, 1999, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, April 21, 1999.

The Board of Trustees of the Hawaii Public Employees Health Fund, Department of Budget and Finance, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

STATE OF HAWAII
DEPARTMENT OF BUDGET AND FINANCE
HAWAII PUBLIC EMPLOYEES HEALTH FUND
P.O BOX 2121
HONOLULU, HAWAII 96805

April 23,1999

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813-2917

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OFC. ... E AUDITOR
STA ... F HAWAII

Dear Ms. Higa:

Re Health Fund Draft Financial Audit

Due to time constraints, our Board of Trustees is unable to fully respond to all of the Auditor's findings at this time. The Board will continue to evaluate their findings and will respond in more detail at a public forum or hearing on Health Fund issues.

Because of the severity of the allegations relating to the improper financial reporting of the Health Fund operations, it is necessary to respond to that issue at this time. The Health Fund undergoes an annual financial audit by independent auditors of the State Comptroller. None of the audits since 1984 contained an adverse opinion, included significant material deficiencies or indicated the Health Fund's financial reports were required to follow GASB standards on public entity risk pools.

Although GASB 10 may be technically applicable, the Health Fund believes the reporting of our financial transactions in expendable trust and agency funds presents a better picture of our operations than an enterprise fund.

The Health Fund management concurs with several of the findings contained in the Draft Financial Audit, especially the Auditor's independent validation of our Board's multi-year efforts in soliciting State Administration and Legislature approval to:

Implement a long-term care insurance benefit plan for public employees and retirees;
2 Provide educational opportunities for our Board members and staff on employee benefit plan administration topics;
3. Acquire investment authority and advisors like the Employees' Retirement System; and
4. Return $17.9 million of excess reserves to our employee members.

The Health Fund management and Board will continue to evaluate the Auditor's findings and will take corrective action as appropriate.

Sincerely,

Cenric S K Ho

CENRIC S.K. HO
Administrator

ATTACHMENT 3

BENJAMIN J. CAYETANO
GOVERNOR

EMPLOYEES' RETIREMENT SYSTEM
HAWAII PUBLIC EMPLOYEES HEALTH FUND

OFFICE OF THE PUBLIC DEFENDER
PUBLIC UTILITIES COMMISSION

STATE OF HAWAII
DEPARTMENT OF BUDGET AND FINANCE
P. O. BOX 150
HONOLULU, HAWAII 96810-0150

EARL I. ANZAI
DIRECTOR

WAYNE H. KIMURA
DEPUTY DIRECTOR

ADMINISTRATIVE AND RESEARCH OFFICE
BUDGET, PROGRAM PLANNING AND
MANAGEMENT DIVISION
FINANCIAL ADMINISTRATION DIVISION

April 21, 1999

RECEIVED
APR 21 4 09 PM '99
OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms

The Department of Budget and Finance (DB&F) has reviewed the draft report of the Financial Audit of the Hawaii Public Employees Health Fund of the State of Hawaii. The Hawaii Public Employees Health Fund (HF) is an administratively attached agency which is governed by a Board of Trustees. They will provide comments directly to your office.

Our comments are directed at the recommendation that the HF work more closely with the Legislature and the Department of Budget and Finance in adoption of a long-term care insurance benefit plan (LTC). Prior requests for funds to implement the LTC were disapproved due to: 1) limited availability of general funds; 2) the provisions of Section 87-3, Hawaii Revised Statutes, which require the employee-beneficiary contributions to fund the cost of the LTC; and 3) other statewide efforts on LTC that were being considered at the time (i.e., Family Hope Program; Joint Legislative Committee on Long-Term Care). The Fiscal Biennium 2000-2001 Executive Budget request currently includes trust funds of $103,000 in FY 00 and $3,000 in FY 01 to implement the LTC. Both the House and Senate versions of the appropriation bill currently appear to include the requested funding.

Thank you for the opportunity to comment on the report.

Aloha,

E. I. ANZAI
Director of Finance

AROADMIN

No. 1 Capitol District Building, 250 S. Hotel Street, Honolulu, Hawaii 96813