Financial Audit of the Employees' Retirement System of the State of Hawaii

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

Report No. 00-10
April 2000

THE AUDITOR
STATE OF HAWAII

Financial Audit of the Employees' Retirement System of the State of Hawaii

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

Conducted by

The Auditor
State of Hawaii
and
KPMG LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 00-10
April 2000

Foreword

This is a report of the financial audit of the Employees' Retirement System of the State of Hawaii for the fiscal year July 1, 1998 to June 30, 1999. 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 KPMG LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Employees' Retirement System of the State of Hawaii.

Marion M. Higa
State Auditor

Table of Contents

Responses of the Affected Agencies

List of Tables

List of Exhibits

Chapter 1
Introduction

This is a report of our financial audit of the Employees' Retirement System of the State of Hawaii. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of KPMG LLP. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawaii and its political subdivisions.

Background

Section 88-22, HRS, establishes the Employees' Retirement System of the State of Hawaii (system) for the purpose of providing retirement allowances and other benefits for public employees. This section grants the system the powers and privileges of a corporation to sue or be sued, transact all of its business, invest all of its funds, and hold all of its cash and securities and other property. The Territorial Legislature established the system in 1925 and operations began on January 1, 1926.

The system is a cost-sharing, multiple-employer public employee retirement system established to provide retirement, disability, and survivor benefits for state and county employees including teachers, professors, police officers, firefighters, judiciary employees, judges, and elected officials. The system engages in the following:

- collects retirement contributions from members and employers;
- provides pre-retirement counseling services; conducts disability hearings and appeals;
- reviews claims for retirement, disability, and death benefits and certifies these benefits for payments;
- processes semi-monthly pension checks to retirees and beneficiaries;
- accounts for and safeguards assets in the system's investment portfolio; and
- invests funds.

Members are covered by the provisions of either a contributory or a noncontributory defined benefit plan. As of March 31, 1999, the system's membership was composed of 27,950 pensioners and beneficiaries who currently receive benefits and 61,164 employees. Of those employees, 2,777 are terminated but vested (eligible for certain benefits) members. The system's participating employers include the State, the City and County of Honolulu, and the counties of Hawaii, Maui, and Kauai. As of June 30, 1999, the system's assets amounted to more than $11 billion. It paid out more than $480 million in benefits and related contributions for FY1998-99.

Organization

Section 88-23, HRS, places responsibility for the general administration and proper operation of the system with the board of trustees, subject to limited administrative control by the Department of Budget and Finance. The board appoints an administrator to oversee the operations of the system's three offices and two branches. The board also appoints a chief investment officer to assist with monitoring the investment portfolio.

Board of Trustees

The board consists of eight members:

- The director of finance of the State, ex officio;
- Four members of the system elected by the members and retirees, and consisting of two general employees, one teacher, and one retiree; and
- Three citizens of the state who are not government employees, appointed by the governor, one of whom shall be an officer of a bank authorized to do business within the state.

The trustees, excluding the director of finance, serve six-year terms.

Offices and branches

Three offices and two branches provide support services for the board.

The Mortgage Services Office plans and coordinates the investment activities of the Member Home Loan Program; develops rules and regulations, policies, and procedures; coordinates procurement activities and prepares requests for proposals for investment consulting, bank custody, actuarial, computer, medical, and other services provided to the system; and prepares contracts and contract amendments to reflect proper terms and conditions.

The Staff Support Services Office plans and coordinates administrative, office, and records management activities for the system; maintains and operates data processing and telecommunications equipment; and participates in the development of program plans, rules and regulations, policies and procedures.

The Information Systems Office plans, develops, and maintains the fully integrated computer system, the Wang System 7120. Major subsystems include the accounting and general ledger, benefit computation, pension payroll and tax reporting, retirement application tracking, pension payment, membership information, and annuity savings subsystems.

The Accounting Branch is responsible for the budgeting, accounting and safeguarding of all assets in the system's investment portfolio to ensure compliance with applicable sections of the HRS, Title 6 of the Hawaii Administrative Rules, federal and state laws, and generally accepted accounting principles.

The Enrollment, Claims and Benefits Branch, which includes the neighbor island branch offices, plans and coordinates the retirement program for State and county employees and retirees; conducts statewide pre-retirement counseling sessions; reviews Medical Board and hearing officers' decisions on disability cases; and participates in the development of program plans, rules and regulations, policies, and procedures.

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 system; to recommend improvements to such systems, procedures, and reports; and to report on the financial statements of the system.

2. To ascertain whether expenses or deductions and other disbursements have been made and all revenues or additions 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

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the system for FY1998-99. We tested financial data to provide a basis to report on the fairness of the presentation of the financial statements. We also reviewed the system's transactions, systems, and procedures for compliance with applicable laws, regulations, and contracts.

We examined the existing accounting, reporting, and internal control structure and identified deficiencies and weaknesses therein. We made recommendations for appropriate improvements including but not limited to forms and records, the management information system, and accounting and operating procedures.

The independent auditors' opinion as to the fairness of the system's financial statements presented in Chapter 3 is that of KPMG LLP. The audit was conducted from July 1999 through October 1999 in accordance with generally accepted government auditing standards.

Chapter 2

The Retirement System's Internal Control Practices Need Improvement

Internal controls are administrative measures instituted 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 Employees' Retirement System of the State of Hawaii.

Management of the retirement system did not fulfill its operational responsibilities, resulting in many deficiencies. Serious deficiencies in contract management resulted in lost income and questionable accountability over moneys held for member benefits. In addition, the system failed to fulfill its basic mission to provide accurate and timely retirement allowances. Moreover, the system has not returned moneys it owes to the State on a timely basis.

Summary of Findings

We found several reportable conditions involving the system's internal control over financial reporting and operations. Reportable conditions are significant deficiencies in the design or operation of internal controls over financial reporting that, in our judgment, could adversely affect the system's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

We found the following reportable conditions:

1. Management failed to plan for delays in contracting for bank custodian and security lending services, which placed the system's assets at risk for five months and contributed to lost income of approximately $1 million.

2. Management did not properly monitor and enforce remedies against the bank custodian, which was in continued noncompliance with contract provisions. This weakened critical internal controls that safeguard the more than $9 billion in investments held for members' benefits. The bank custodian's failure to perform these control procedures created additional work for the system's staff, who detected millions of dollars in recording errors. In addition, management has not enforced remedies of $12,500 in discounts against the bank custodian for failing to adhere to contract provisions.

3. As of June 30, 1999, the system owed approximately $17 million to the State for overpayments of the State's portion of the annual required contribution.

4. Management failed to properly plan its "Data Purification Project" to verify membership data, which resulted in untimely execution of contracts and extensions, an unforeseen sole source contract, and little if any improvements to the present benefits process. Despite the expenditure of approximately $740,000 since the project's inception in December 1992, the system has not been able to reduce the time it spends in calculating and verifying pension benefits.

5. Management has not ensured timely and accurate pension payments to approximately 1,100 retirees as of June 30, 1999, who continue to receive estimated pension payments. These estimated benefit payments generally result in an underpayment to the retiree or beneficiary. We found a number of retirees whose pension benefits were underpaid by as much as $15,870. Because management has pursued other priorities, the system has not fulfilled its basic mission of providing timely and accurate pension payments.

We also found another condition not considered reportable, but is a matter that should be communicated in accordance with auditing standards. Act 100, Session Laws of Hawaii (SLH) 1999, provides for the system's investment earnings in excess of 10 percent to be used to defray the State's and counties' contributions to the system. However, we believe that not allowing the system to keep all of its investment earnings has reduced employer contributions for the next two years, but will likely increase future employer contributions to the system to pay out future benefits.

Management Has Failed to Ensure the Timely Execution of Contracts and to Safeguard Members' Moneys

An eight-member board of trustees is responsible for the general administration and proper operation of the system and has appointed an administrator to carry out such operations. The administrator hires staff, including branch and section heads, to direct and perform the operational requirements.

In its operations oversight, management failed to execute the bank custodian and securities lending contracts in a timely manner. Since the bank custodian holds a majority of the system's $9 billion worth of investments, an unexecuted contract seriously jeopardizes the system's accountability over these investments. Furthermore, the delay in executing a securities lending contract with the bank custodian resulted in approximately $1 million in lost income.

Services performed prior to execution of bank custodian contract places members' moneys at risk

The bank custodian, Bankers Trust Company, held approximately $7.5 billion of the system's investments during the five months from March 1, 1997 to July 24, 1997, without an executed contract. These investments are extremely critical for the payment and funding of pension benefits. Although bank custodian fees were not charged during this period, the system's management exposed the system and the investment funds earmarked for its members to unnecessary and excessive business risk.

The system has a fiduciary responsibility, under Section 88-23 of the Hawaii Revised Statutes, for the safekeeping of its investment assets. The system's custodian provides safekeeping services for the majority of the system's assets. A properly executed contract is essential to ensure that the type and scope of services are agreed upon, and that the roles and responsibilities of the system and the bank custodian are clearly delineated to avoid confusion or misunderstanding. Contracts must be properly executed prior to services being rendered. Without the legal basis of a contract, there is no assurance that the services being provided are those that are required.

We were informed that the delay was due to the large number of parties required to negotiate, draft, and approve the contract: the system, the Department of the Attorney General, the bank custodian, and the system's investment consultant. However, management should have anticipated these delays by starting the procurement and contracting process earlier. Instead, management did not present its recommendation for the new bank custodian until the board meeting on December 9, 1996—21 days before the original expiration of the existing bank custodian contracts. These contracts, which were to expire on December 31, 1996, were extended to February 28, 1997.

To worsen matters, the draft contract was not submitted to the attorney general until December 24, 1996. Although a 65-day time frame to review a five-year contract at $150,000 each year may be a reasonable request of the attorney general, other contracts have required several months to review. These facts should have been considered by management. Furthermore, management did not execute the contract until five months after the preceding extended contracts expired. Bank custodian services provided by the contracted Bankers Trust Company were without contractually defined roles and responsibilities for a five-month period. Consequently, the system's investments were placed in jeopardy and would have been at risk had any legal problems arisen during the unexecuted contract period.

Untimely securities lending contract results in approximately $1 million of lost income

Due to the delays in executing the bank custodian contract, the system did not participate in a securities lending program during a five-month period (March 1, 1997 to July 30, 1997). Management's failure to plan for these delays, which included a lengthy review process by the attorney general, contributed to approximately $1 million in lost securities lending income.

A customary practice for public employee retirement systems to both 1) preserve their investment base and 2) earn consistent positive returns is to implement a securities lending program. Under such a lending program, a system's bank custodian lends the system's securities to borrowers previously approved by the system in exchange for collateral such as cash, money markets, treasury notes, securities issued or guaranteed by the U.S. government and/or letters of credit. The custodian simultaneously agrees to return the collateral to borrowers for the same securities in the future. The collateral is a low risk financial instrument that has a distinct and marketable value.

A securities lending program operates under the following conditions. Borrowers are required to deliver collateral for each security that is loaned. The collateral must be higher in value than the security loaned, as specified in a contract threshold. The collateral is then revalued daily to ensure that its value is maintained. If the daily value falls below the threshold, then additional collateral is required of the borrower. In addition, the bank custodian indemnifies the retirement system by agreeing to purchase replacement securities or to return cash collateral to the system in the event the borrower fails to return the loaned securities or pay distributions.

This process protects the system's financial interests and allows the system to preserve its investment base and/or maintain its investment value. The growing investment base, in turn, provides a greater lending base for the lending program. Continued investment growth is then achieved through the purchase of investments, which produce positive returns through dividends or interest income, and through the appreciation of the system's investments.

The system's net income from securities lending activities for an 8-month period (July 1, 1996 to February 28, 1997), and an 11-month period (August 1, 1997 to June 30, 1998) amounted to approximately $1,182,000 and $2,412,000 respectively—an average of approximately $190,000 per month. If the system had participated in a lending program for the five-month period it could have earned approximately $950,000. We were informed that Bankers Trust Company would not administer a securities lending program until a securities lending contract was executed. The failure of management to execute a securities lending contract in a timely manner hampered the system's ability to meet its investment objectives—to maintain its base and earn positive returns.

Recommendation

Management should allow sufficient time to negotiate and execute contracts before existing contracts terminate in order to protect the interests of the system and allow it to meet its investment objectives.

Management Has Not Adequately Acted on Nonperformance by the Bank Custodian and Has Not Enforced Certain Remedies for Noncompliance

Management is responsible for ensuring that the bank custodian provides the system with timely and accurate statements of funds. Neither management nor the custodian satisfactorily performed their duties. Management's failure to enforce the contract requirements with Bankers Trust Company could jeopardize the board's actions or decisions.

The services of a new bank custodian, Bankers Trust Company, were procured beginning March 1, 1997. From that time forward, Bankers Trust Company failed to meet key contract terms. The most significant example of non-compliance is that Bankers Trust Company did not complete the required reconciliations between its statements of the fund's assets and the individual investment managers' reports. This non-compliance and other related problems by Bankers Trust Company continued for more than two years. Such a neglect of fiduciary duty by Bankers Trust Company raises serious questions about the system's management and its ability to monitor and enforce critical contract provisions.

Management's failure to enforce the investment reconciliation by the bank custodian in a timely manner jeopardizes the safeguarding of members' moneys

Attachment 1, Section 10, "Accounts and Reporting," of the bank custodian contract states that all custodian reports and statements shall be audited and reconciled to investment managers' reports. Such reconciliations serve as an important internal control to ensure that the investment managers' transactions and any income due to the system are properly and timely accounted for in the custodian reports.

For 28 months of the contract period, management failed to enforce contract provisions on Bankers Trust Company to complete the required reconciliations. Instead, the system's staff performed these time-consuming reconciliations on a selected basis to determine whether Bankers Trust Company's reports agreed with the investment managers' reports. In other words, the system's staff performed additional work that the custodian was paid and contractually obligated to perform. The staff's effort, however, did uncover errors by the bank custodian in the recording of investments. For example, Bankers Trust Company did not record the purchase of a fixed income security executed on June 23, 1999 amounting to $5,028,906 on the monthly statement ending June 30, 1999. Although this purchase could have been recorded later, the failure of management to require the bank custodian to perform the reconciliation control procedure does not guarantee the recording of a late entry. This lack of reconciliation procedure places an unnecessary burden on the system and its accountability over its investments. Without a reconciliation procedure, there is no reliability of accurate investment reporting.

Untimely reporting by the bank custodian weakens management's ability to make accurate decisions

Another provision in Attachment 1, Section 10, "Accounts and Reporting," of the bank custodian contract requires Bankers Trust Company to provide the system with monthly and annual statements of the system's investment assets. These statements are to be submitted within seven business days after the receipt of the last investment managers' reports or at the end of each calendar month or fiscal year. Management and the custodian agreed to use the end of the calendar month as the start date for the seven-day statement report period.

The system's staff updates their general ledger based on the custodian reports. Out of a 28-month contract period, Bankers Trust Company was not timely for 24 months. The company did not provide statements of assets to the system so that the general ledger could reflect current amounts. These monthly and annual statements are used to update internal financial reports, which may be used and relied upon by the board of trustees and administrator for their investment and operational decisions. However, management failed to hold the custodian accountable, and thus could impede management's and the board's ability to make decisions based on accurate financial data.

Remedies in the bank custodian contract for nonperformance have not been enforced

Attachment 1, Section 10, "Accounts and Reporting," of the bank custodian contract also states that, if the bank custodian statements are delayed beyond the seven-day period, the bank custodian shall discount its fees for the month by 10 percent. Bankers Trust Company's contracted fee is $12,500 per month, or $150,000 annually. For 10 out of 22 months, the system did not receive the 10 percent reduction in fees that it was entitled to, which would have amounted to $12,500. The system was informed by Bankers Trust Company that the delays were due to the unanticipated magnitude and complexity of the monthly transactions, late submission of the investment manager reports, and the company's own internal backlog.

Under terms of the contract, no fees were imposed for the first six months of the contract from March 1, 1997 to August 30, 1997. To further relieve Bankers Trust Company of its duties under the contract, management did not enforce the discount from September 1, 1997 to March 31, 1998. We were informed that the fee waiver was related to the system's partial responsibility for the delays in receiving the statements, as the system's staff had spent time modifying the format of the statements. However, the terms of the contract require the submitted statements be audited and reconciled to investment managers' reports by the bank custodian, not the system's staff. Bankers Trust Company did not audit nor reconcile its records to the investment managers' reports; therefore, the system should have received the discount for all 22 months.

The system notified Bankers Trust Company, through discussions and in a letter dated January 20, 1998, of its dissatisfaction with the poor level of services provided. It informed Bankers Trust Company that if the situation continued, the system would consider contract termination. Although problems continued, the contract remained in effect during the audit period, which ended June 30, 1999. Management's decision not to enforce provisions for discounts for and tolerance of Bankers Trust Company's nonperformance indicates a neglect of fiduciary duty.

Recommendations

We recommend that the board require management to closely monitor the custodian's performance and submit regular reports on appropriate and timely measures taken to strictly enforce all contract provisions. We also recommend that management report regularly to the board on the custodian's performance.

The System Owes the State $17 Million

At June 30, 1999, the system owed the State over $17 million in excess employer contributions. This excess amount occurred as a result of the methodology for assessing the State's annual contribution for state employees working on federal and/or special funded projects. As shown in Table 2.1, the amount due to the State for excess employer contributions has been growing at an accelerated pace each year and there have been no significant refunds to the State over a four-year period. Interest has not accrued on the excess amounts due the State. Management's failure to timely return the $17 million without any earned interest jeopardizes the financial welfare of other state programs.

Table 2.1
Federal and/or Special Fund Moneys Due to State

Year	Due to State	Amount Refunded to State's General Fund
FY1995-96	$4,331,039	$235,900
FY1996-97	6,005,902	—
FY1997-98	13,245,778	—
FY1998-99	17,047,221	—

The State's portion of the annual employer contribution is allocated to the State's general fund and the various federal/special funds. At the beginning of a fiscal year, the State allocates 80 percent of state appropriations (employer contributions) to the general fund and 20 percent to the federal/special funds, an estimate based on historical rates. The general fund remits its 80 percent allocation to the system on a monthly basis while the federal/special funds remit their payments on the basis of a pension assessment percentage that is charged semi-monthly to the actual wages of state employees working in federal/special funded programs.

After the end of a fiscal year, a consultant compares the fiscal year's actual federal/special fund wages to total wages to determine the federal/special funds' proper share of the State's contribution. This computed amount is compared with the actual amount collected by the system. Any over- or under- payment is factored into the pension assessment percentage that will be charged on federal/special funded wages for the next two fiscal years following the year under review. This is to ensure that an accurate assessment will be imposed in the next biennium budget period. As a result, any over- or under- payment relating to federal/special funds should be cleared two years subsequent to the current fiscal year.

Management indicated that the system did not refund the State the adjusted federal/special fund amounts because the system was awaiting the consultant's report for FY1996-97. To fulfill its fiduciary responsibility to the State, management must return excess employer contributions to the state treasury.

Recommendations

We recommend that the system refund excess employer contributions to the State general fund in a timely manner. In addition, we recommend that the system initiate efforts to receive 100 percent of employer contributions, including federal/special funds. The Department of Budget and Finance should assure the monitoring over and collection of federal/special fund pension assessments, since it hires and reviews the work of the consultant who determines the pension assessment. Moreover, the department is responsible for the custody and safekeeping of state funds; therefore, excess contributions would remain in the state treasury without additional processing time for the system to generate and send a check.

Management Failed to Properly Plan and Execute Its Data Purification Project, Wasting Resources

On July 1, 1989, the system began operations on its pension benefits computer system, which was developed in-house. Prior to this date, the system maintained pension information on manual ledger cards and personnel forms kept on file. The system embarked on its Data Purification Project (project) in December 1992 in an effort to clean up past data and to improve the accuracy and timing of its pension benefits program. Since 1992, the project has grown in scope and in number of contracts, which presently aggregate to over $900,000. Table 2.2 reflects the chronology of contracts for the project.

The original objectives of the project were to input manual pension information from ledger cards and personnel forms into a database, calculate the applicable member service credits, confirm the pension information with members, and download the pension information into the system's new computer system. Meeting these objectives would purportedly reduce the calculation time for pension benefits. The downloaded information would be combined with current data being updated and recorded in the computer system. Management believed that continuing the project would not be necessary for the period subsequent to June 30, 1989 as the computer system would then have the capability of calculating member service credits henceforth.

Table 2.2
Summary of Data Purification Project Contracts
As of June 30, 1999

Phase	Contract Execution Date	Contract Price	Contractor	Effective Dates Per the Contract	Actual Service Dates
I	12/1/92	$498,100	HDEP International, Inc. (prime) William M. Mercer, Inc. (sub)	11/30/92 to 5/31/94 No extension	12/92 to 11/96
TPP	11/4/98	$80,000	Systecon, Inc.	12/1/96 to 11/30/97	1/97 to 10/98
Post-TPP	4/30/99	$150,000	Systecon, Inc	12/1/98 to 9/1/00	8/98 to present
OSCAR	4/30/99	$174,000	Systecon, Inc.	12/1/98 to 9/1/00	5/99 to present
Total		$902,100			

In 1993 and 1994, the system mailed statements to its members based on information subsequent to July 1, 1989. However, the system discovered through member responses that its computer system was not accurately calculating member service credits, due to inaccurate salary and other personnel information. The computer system had calculated member service credits based on salary information downloaded from the State's and counties' payroll systems that contained inaccurate salary information.

In addition, the computer system was unable to compare the downloaded salary information with data contained in personnel forms. For example, if a new employee began work on January 6 but received his/her first paycheck for the pay period ending February 5, the computer system incorrectly calculated no service for the month of January instead of one full month based on the personnel form. In other words, the computer system incorrectly used the pay date based on the downloaded payroll systems rather than employment date to compute the years of service. Since it was not able to interface with personnel forms, verification of service credits through a comparison of payroll with personnel history information was not performed.

At this point, the retirement system attempted to remedy the problem by using a software program developed under Phase I of the project instead of modifying the existing computer system. Management's decision was based on the additional costs required to increase the storage capacity and technical features to accurately perform the service credit calculation. Management also decided not to modify the Wang computer system since the company was no longer in business and the retirement system planned to replace the existing computer system with another one. More than five years have passed with the Wang system's continued use. Implementation of a new computer system is not anticipated for another two or three years. The replacement system was to use information from the Total Purification Project (TPP) and Post-TPP phases, both of which involved calculating member service credits for the periods July 1, 1989 to June 30, 1996.

As part of the same contract for the Post-TPP phase, the retirement system also asked the consultant to develop the Online Service Credit Adjustment and Reconciliation (OSCAR) system. OSCAR has the ability to download information into the computer system to generate annual member statements, provide a single source of current, verifiable service credit information that can be updated; afford an automated means to "purify" and adjust service credits; and simplify and expedite the computation of estimated and finalized retirement benefits. Included as part of the OSCAR contract is the calculation of member service credits for the period July 1, 1996 to June 30, 2000.

When management first contracted services for the Data Purification Project, it did not plan on extending those services beyond two years. It also did not seek to retain ownership rights to the software program developed as part of contract services received. In fact, management was initially only concerned with contracted services that would clean up data prior to July 1, 1989. However, management later decided to include services up through 2000. Management's failure to properly plan the project resulted in the receipt of services without an executed contract or contract extension on the incomplete contract. Moreover, the project has not yet reduced the processing time for pension benefits, and future benefits of the project continue to diminish as members retire (since their retirement information will have been manually reviewed and verified).

Untimely execution of contracts places the system at risk

The consultant for the initial data purification project provided services without executed contracts during the periods January 1997 to October 1998 and August 1998 to April 1999. In both cases, the system did not make payments until the contracts were executed on November 4, 1998 and April 30, 1999, respectively—well after the services had been provided. Invoices were received as of November 5, 1998 ($80,000) and April 20, 1999 ($150,000) and payments were made by the system on November 20, 1998 and April 30, 1999 for the respective contracts. In addition, we noted that a contract extension was not executed for Phase I even though the contractual completion date was May 31, 1994 and the actual completion occurred in November 1996 (see Table 2.2).

A properly executed contract is essential to ensuring that the type and scope of services agreed upon and the roles and responsibilities of both the system and the consultant are clearly delineated to avoid confusion or misunderstanding. It is also essential that contracts be properly executed prior to any services being rendered. Without the benefit of a contract, there is no assurance that services being provided are those that are required. Additionally, providing services without contractually defined roles and responsibilities puts the system in jeopardy should any legal problems arise.

The TPP contract was executed on November 4, 1998 upon completion of the consultant's services because of the consultant's uncertainty of his ability to fulfill the contract. We were informed that the delay in execution of the Post-TPP contract dated April 30, 1999, was due to the review by the attorney general. However, the consultant had already agreed to the performance terms of the draft contract prior to the attorney general's review. In both cases, management reportedly made a business decision, that is, a decision based on expediency and curtailing financial loss, to have the consultant perform the services without executed contracts. Management also allowed the consultant to continue with the project based on its previous relationship with the consultant and with the stipulation that payments would not be made until completion of the project and/or proper execution of the contract. The Phase I contract was not extended prior to the contractual completion date reportedly due to an oversight. However, once the Phase I contract was completed, it was impossible for the system to extend the contract.

Management failed to retain ownership rights to a software program developed as part of contract

The consultant on the Phase I project, William M. Mercer, Inc. (Mercer), developed a software program to calculate member service credits by comparing salary history with personnel forms. Management's failure to properly plan for and consider the ownership rights to this program resulted in the consultant retaining title to the software program. Years later, management realized that it would have been beneficial to acquire the software program. Therefore, when the system later initiated a sole source contract with Systecon, Inc. for $80,000, Mercer required the system to use Systecon as a condition to obtaining the rights to use the original software program. The owner of Systecon, Inc. had developed this software program while employed by Mercer.

Good business practice dictates that each contract contain language clearly specifying that ownership rights and title to all products, concepts, and materials developed as part of a contract will belong to the system. Management did not foresee the need to include such a clause in its original contract with Mercer. Instead, it planned to rely on the pension information calculated by the computer system for the periods subsequent to June 30, 1989; it did not anticipate that the consultant would develop a software program to calculate member service credits as well. If management had acquired the software program initially, the system could have saved a portion of the $80,000 from its contract with Systecon.

Seven years of effort have not improved the pension benefits process

Despite the system's significant investment in the data purification project since December 1992, the process has not improved. Approximately $740,000 in payments to consultants have been made as of June 30, 1999 in an effort to reduce manual calculations and verifications associated with the pension benefit process. While the system believes that the project will result in more efficient benefits processing, it has yet to realize these benefits.

The project has not changed the time-consuming and labor-intensive process of pension benefit calculations and verification. The system's staff continue to expend a significant amount of time reviewing pension information. Approximately 30 percent, or 12,700 out of 42,900, of members whose data was "purified" as part of the first phase of the project have already retired and have had their pension benefits manually calculated. In addition, more of the 42,900 members will be retiring between July 1, 1999 and the project's eventual completion in the year 2000. For such retired members, benefits from the project will never be realized.

Recommendations

We recommend that the system execute contracts prior to the receipt of services, extend contracts as necessary in a timely manner, include all pertinent contractual clauses, and continue to work with the consultant to complete the data purification project's purpose of expediting benefits processing.

Management Has Not Ensured Timely and Accurate Pension Payments to More Than 1,000 Retirees

Management is responsible for providing timely and accurate pension payments to qualified retirees. Pension payments to retirees involve a two-step process. Initially, calculations are performed and payments are remitted to retirees based on estimated pension data. Generally, the estimated pension payment excludes vacation and sick leave data. This data is submitted to the system after the employee's retirement, at which point a finalized pension payment is calculated, and if necessary, retroactive adjustments are made back to the employee's retirement date.

We found that management failed to fulfill its responsibility of providing timely and accurate pension payments to 1,100 retirees as of June 30, 1999. These retirees have been waiting on average about one year and in some cases up to two years for the finalization of their pensions. Meanwhile, they continue to receive estimated pensions, which often represent lower amounts than their final pensions. For example, we reviewed a list of retirees and beneficiaries finalized during the period July 1, 1998 to June 30, 1999, and found that approximately 99 percent of the retirees sampled were underpaid their pension benefits. The underpayments for the period between their retirement dates and finalization dates generally ranged from $100 to $3,000, but were as much as $15,870.

We were informed that delays were attributed to the shifting of system resources, late submission of audited vacation and sick leave reports from the state and county personnel offices, lump sum vacation payments, and verification of certain retirement data by state departments and counties. Nonetheless, one year is too long for retirees to wait to receive final pension calculations, especially since these underpayments do not accrue interest.

Recommendation

We recommend that management work closely with the state and county departments to obtain timely information and continue to work toward completion of the Data Purification Project in order to reduce the amount of manual calculations and verifications.

The System's Approximately One-Half Billion Dollars of Unfunded Liability Could Increase Due to Recent Legislation

Act 100 of the 1999 Regular Session amended Section 88-107, HRS, to be applied retroactively to FY1996-97 and FY1997-98, so that all actuarial investment earnings in excess of 10 percent reduce the amount contributed by the State and the counties. This resulted in an immediate reduction of moneys to be contributed by the State and counties. However, we found that this legislation was detrimental to the system's unfunded actuarial accrued liability. In order to maintain benefits, the system will have to receive increased employer contributions in the future to ensure the sufficiency of funds to pay out future pension benefits.

Prior to Act 100, FY1996-97 and 1997-98 actuarial investment earnings in excess of 10 percent were retained by the system and did not reduce the actuarially-determined state and counties employer contributions for the short-term. Allowing the system to retain its excess investment earnings helped to reduce its unfunded actuarial accrued liability from $1.4 billion in FY1994-95 to $474 million in FY1998-99. The law change reduces employer contributions for the next two years, but will likely increase future contributions from the State and counties to fund the system.

Recommendation

We recommend that the system continue to monitor its unfunded liability and work with the Legislature to ensure continued improvement of its financial condition and reduction of future employer contributions.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Employees' Retirement System of the State of Hawaii (System) as of and for the fiscal year ended June 30, 1999. This chapter includes the independent auditors' report and the report on compliance and internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* as they relate to the System. It also displays the System's financial statements together with explanatory notes, required supplementary information, and supplementary information.

Summary of Findings

In the opinion of KPMG LLP, based on their audit, the financial statements present fairly, in all material respects, the plan net assets of the System as of June 30, 1999, and the changes in plan net assets for the year then ended in conformity with generally accepted accounting principles. KPMG LLP noted certain matters involving the System's internal control over financial reporting and its operations that the firm considered to be reportable conditions. KPMG LLP also noted that the results of its tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the combined statement of plan net assets of the Employees' Retirement System of the State of Hawaii (System) as of June 30, 1999, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the System as of June 30, 1999, and the changes in plan net assets for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 8, 1999 on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

The schedules of funding progress and employer contributions and the year 2000 information included in Exhibits C through E, respectively, are not a required part of the basic financial statements, but are supplementary information required by the Governmental Accounting Standards Board, and we did not audit and do not express an opinion on such information. We have applied to the schedules of funding progress and employer contributions certain limited procedures prescribed by professional standards, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the schedules. We were unable to apply certain of these limited procedures to the year 2000 information because of the nature of the subject matter underlying the disclosure requirements and because sufficiently specific criteria regarding the matters to be disclosed have not been established. In addition, we do not provide assurance that the System is or will become year 2000 compliant, that the System's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the System does business are or will become year 2000 compliant.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of the System taken as a whole. The supplementary information included in Exhibits F through J is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ KPMG LLP

Honolulu, Hawaii
October 8, 1999

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Auditor
State of Hawaii:

We have audited the financial statements of the Employees' Retirement System of the State of Hawaii (System), as of and for the year ended June 30, 1999, and have issued our report thereon dated October 8, 1999. 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.

Compliance
As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, 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 System'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 certain matters involving the internal control over financial reporting and its operation that we consider to be reportable

conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the System's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Chapter 2 of this report.

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that misstatements 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 internal control over financial reporting would not necessarily disclose all matters in 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 none of the reportable conditions described above are material weaknesses.

This report is intended solely for the information of the Auditor, State of Hawaii, and the management of the System and is not intended to be and should not be used by anyone other than these specified parties.

/s/ KPMG LLP

Honolulu, Hawaii
October 8, 1999

Description of Financial Statements, Required Supplementary Information, and Supplementary Information

The following is a brief description of the financial statements, required supplementary information, and supplementary information audited by KPMG LLP, which are located at the end of this chapter.

Financial statements

Combined Statement of Plan Net Assets (Exhibit A). This statement presents the System's assets, liabilities, and net assets at June 30, 1999.

Statement of Changes in Plan Net Assets (Exhibit B). This statement presents the additions to, deductions from, and net increase in the System's net assets for the fiscal year ended June 30, 1999.

Required supplementary information - unaudited

Schedule of Funding Progress (Exhibit C). This schedule presents historical trend information about the actuarially determined funded status of the plan from a long-term, ongoing plan perspective and the progress made in accumulating sufficient assets to pay benefits when due.

Schedule of Employer Contributions (Exhibit D). This schedule presents historical trend information about the annual required contributions of the employers and the contributions made by the employers in relation to the annual required contributions.

Year 2000 Disclosures (Exhibit E). This disclosure describes the stages of work in process or completed to make the System's computer systems and other electronic equipment that are critical to conducting operations Year 2000 compliant at June 30, 1999.

Supplementary information

Combining Statement of Plan Net Assets – All Trust and Agency Funds (Exhibit F). This statement presents the System's assets, liabilities, and net assets by trust and agency fund type at June 30, 1999.

Changes in Net Assets Held in Trust for Pension Benefits (Exhibit G). This statement presents the additions to, deductions from, and net increase or decrease in the System's specific funds' net assets, as defined in Section 88-109, HRS, for the fiscal year ended June 30, 1999.

Statement of Changes in Assets and Liabilities – Social Security Fund (Exhibit H). This statement presents the additions to and deductions from the Social Security Contribution Fund assets and liabilities for the fiscal year ended June 30, 1999.

Supplemental Schedule of Administrative Expenses (Exhibit I). This schedule presents a listing of the System's administrative expenses by type for the fiscal year ended June 30, 1999.

Supplemental Schedule of Investment and Securities Lending Activities Expenses (Exhibit J). This schedule presents a listing of the System's investment and securities lending activities expenses by type for the fiscal year ended June 30, 1999.

Notes to Financial Statements

Explanatory notes which are pertinent to an understanding of the financial statements and financial condition of the System are discussed in this section.

Note 1 – Description of the System

General

The Employees' Retirement System of the State of Hawaii began operations on January 1, 1926, having been established by the Territorial Legislature in the preceding year. The System is a cost-sharing, multiple-employer public employee retirement system established to administer a pension benefits program for all State and county employees, including teachers, police officers, firefighters, corrections officers, judges and elected officials.

Employer, pensioner and employee membership data as of March 31, 1999:

Employers:	
State	1
Counties	4
Total employers	5
Pensioners, beneficiaries and terminated vested members:	
Pensioners and beneficiaries currently receiving benefits and terminated vested members entitled to benefits but not yet receiving benefits:	
Police officers, firefighters and corrections officers	2,208
All other pensioners and beneficiaries	25,742
Terminated vested members	2,777
Total pensioners, beneficiaries and terminated vested members	30,727
Current employees:	
Vested:	
Police officers, firefighters and corrections officers	3,649
All other employees	28,239
Nonvested:	
Police officers, firefighters and corrections officers	882
All other employees	25,617
Total current employees	58,387

Financial reporting entity

As required by generally accepted accounting principles, these financial statements present the System (the primary government) as a separate reporting entity from the State of Hawaii (State). The System is not part of the State's financial reporting entity because it is a separate legal entity that is fiscally independent of the State. The System was established by Chapter 88 of the Hawaii Revised Statutes and is governed by a Board of Trustees (Board) as discussed below. As the primary government, the System has included the Social Security Contribution Fund in its financial statements since the Social Security Contribution Fund is not a legally separate entity.

The Board administers the System on behalf of public employees of both the State and county governments. Except for limited administrative functions, the State does not have the power to supervise or control the Board in the exercise of its functions, duties and powers. The Board consists of eight members. The State Director of Finance is a statutory member of the Board. Four members of the Board are elected by members of the System and the other three members of the Board are appointed by the governor. Decisions are made with the concurring vote of five members of the Board. The Board appoints the Administrator and engages actuarial and other services required to transact the business of the System.

Benefits

Members of the System belong to either the contributory or noncontributory plan. Employees covered by Social Security on June 30, 1984 were given the option of joining the noncontributory plan or remaining in the contributory plan. All new employees hired after June 30, 1984, who are covered by Social Security, are generally required to join the noncontributory plan. Most members of the contributory plan are required to contribute 7.8% of their salary. Both plans provide a monthly retirement allowance based on the member's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the payment of salary in lieu of vacation, or the three highest paid years of service if the employee became a member prior to January 1, 1971. The AFC for members hired on or after this date is based on the three highest paid years of service excluding the payment of salary in lieu of vacation. Vesting requirements for the contributory and noncontributory plans are five and ten years, respectively.

Ordinary disability retirement benefits require a minimum of ten years of service, whereas service-connected disability resulting from a job related accident does not have a service period requirement. There is no age requirement for disabilities under both plans.

Ordinary death benefits under the contributory and noncontributory plans require at least one year and ten years of service, respectively. There is no service requirement for service-connected death benefits under both plans.

Retirement benefits for certain groups of contributory members, such as police officers, firefighters, some investigators, sewer workers, judges and elected officials, vary from general employees. All contributions, benefits and eligibility requirements are governed by Chapter 88 of the Hawaii Revised Statutes.

Every retiree's original retirement allowance is increased by 2-1/2 percent on each July 1 following the calendar year of retirement. This cumulative benefit is not compounded and increases each year by 2-1/2 percent of the original retirement allowance without a ceiling (2-1/2 percent of the original retirement allowance the first year, 5 percent the second year, 7-1/2 percent the third year, etc.).

Note 2 – Social Security Contribution Fund

The Social Security Contribution Fund (Contribution Fund) was established under Section 88-224 of the Hawaii Revised Statutes for the following purposes:

To receive all Federal social security contributions withheld from State and county employees, employers' matching contributions, and interest and penalties on unpaid amounts;

To receive any appropriations to the Contribution Fund;

To pay amounts required to be paid to the Internal Revenue Service (IRS); and

To invest and collect income on resources held by the Contribution Fund.

Effective January 1, 1987, all governmental agencies, with the exception of the State (employer's contribution only), remit social security contributions directly to the IRS. Social security contributions withheld from employees are remitted directly to the IRS by the employers.

Note 3 – Summary of significant accounting policies

A summary of the significant accounting policies consistently applied in the preparation of the accompanying financial statements follows:

Basis of accounting

The financial statements are prepared using the accrual basis of accounting. Employer and member contributions are recognized in the period in which the contributions are due. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Investments

Pursuant to Section 88-119 of the Hawaii Revised Statutes, the System may invest in real estate loans and mortgages; government, corporate and certain other obligations; preferred and common stocks; real property; and other securities, including alternative investments which represent venture capital investments, and futures contracts.

Investments are reported at fair value. Where appropriate, the fair value includes disposition costs. Short-term investments are reported at cost, which approximates fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Securities transactions are reported on a trade date basis. Investment sales proceeds and investment purchases payable represent unsettled sales and purchases of securities. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. The fair value of real estate investments and real estate owned are based on independent appraisals and estimated values.

Interest allocation

Pursuant to Sections 88-21 and 88-107 of the Hawaii Revised Statutes, the Board shall annually allocate interest and other earnings of the System to the funds of the System, as follows:

1. Annuity Savings Fund – Fixed at 4-1/2 percent per annum.

2. Expense Fund – To be credited with all monies necessary to pay the administrative expenses of the System.

3. Pension Accumulation Fund – To be credited with any remaining investment earnings. In June 1999, the Legislature of the State of Hawaii enacted Act 100, which amends Section 88-107 of the Hawaii Revised Statutes to apply 100 percent of the actuarial investment earnings in excess of 10 percent to the employers' contributions in fiscal years 1997 and 1998. Beginning in fiscal year 1999, 100 percent of the System's investment earnings shall be deposited in the Pension Accumulation Fund.

Risk management

The System reports liabilities related to certain types of losses (including torts, theft of, damage to, or destruction of assets, errors or omissions, natural disasters and injuries to employees) when it is probable that the losses have occurred and the amount of those losses can be reasonably estimated.

Use of estimates

The preparation of 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 financial statements and the reported amounts of additions and deductions during the reporting period. Actual results could differ from those estimates.

Note 4 – Description of funds

Section 88-109 of the Hawaii Revised Statutes requires the establishment and maintenance of specific funds. The funds and their purposes are described hereunder:

1. **Pension Accumulation Fund -** To accumulate contributions made by the State and counties, transfers of retired members' contributions plus related interest income from the Annuity Savings Fund and income from investments. All pension benefits, including the pensioners' bonus and the minimum pension benefit beginning July 7, 1998 are paid through this fund.

2. **Annuity Savings Fund -** To accumulate members' contributions and related interest income. Upon a member's retirement, the accumulated contributions and related interest income are transferred to the Pension Accumulation Fund or refunded to the member upon termination.

3. **Expense Fund -** To pay all the expenses necessary in connection with the administration and operation of the System. The Board estimates the amount of money necessary to be paid into the expense fund for the ensuing biennium to provide for the expense of operation of the System, and pays that amount into the expense fund from the investment earnings of the System, subject to review by the Legislature and approval by the governor.

4. **Minimum Pension Fund** - Prior to July 7, 1998, the Minimum Pension Fund received appropriations made by the State and counties for the purpose of paying minimum pensions and to pay each retirant a minimum pension under Section 88-89 of the Hawaii Revised Statutes. In July 1998, the Legislature of the State of Hawaii enacted Act 151 eliminating the Minimum Pension Fund. As a result, since July 7, 1998, minimum pensions are to be paid from the Pension Accumulation Fund. The Minimum Pension Fund balance at July 7, 1998 was refunded to the State and counties during fiscal year 1999.

Net assets held in trust for pension benefits as of June 30, 1999 are as follows:

Pension Accumulation Fund	$8,776,158,199
Annuity Savings Fund	902,196,221
Expense Fund	1,405,084
Total net assets held in trust for pension benefits	$9,679,759,504

The Pension Accumulation and Expense Fund balances previously reported at June 30, 1998 have been restated to reflect the return of unexpended and unobligated Expense Fund balances as of June 30, 1998 to the Pension Accumulation Fund. The effects of the restatement of the respective fund balances as of June 30, 1998 are as follows:

	Pension Accumulation Fund	Expense Fund
Fund balance at June 30, 1998, as previously reported	$8,164,118,043	$4,176,441
Return of unexpended and unobligated Expense Funds	4,092,294	(4,092,294)
Fund balance at June 30, 1998, as restated	$8,168,210,337	$84,147

Note 5 – Contributions

The System's funding policy provides for periodic employer contributions at actuarially determined rates, expressed as a percentage of annual covered payroll, such that the employer contributions, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate sufficient assets to pay benefits when due. The funding method used to calculate the total employer contribution required is the entry age normal actuarial cost method. Under this method, the total employer contribution is comprised of the "normal cost" plus the level annual payment required to amortize the unfunded actuarial accrued liability over the remaining period of 21 years from July 1, 1995. The employer normal cost is the level percentage of payroll contribution required to pay all benefits. Actuarial gains and losses resulting from differences between actual and assumed experience are reflected in the employer unfunded accrued liability.

Most members of the contributory plan are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the department of the prosecuting attorney and the attorney general, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary.

Employer and member contributions are governed by Chapter 88 of the Hawaii Revised Statutes.

Note 6 – Cash deposits and investments

The System's policy is to invest cash in excess of operating requirements in income producing investments. The carrying amount of the System's total deposits (including those classified as short-term investments) as of June 30, 1999, net of a bank overdraft of $3,447,133, was $16,129,806 (which includes cash and time deposits of $2,500,000). Total bank balances of these deposits amounted to $20,418,290. Of the bank balances, $2,536,180 was covered by the Federal Deposit Insurance Corporation or by collateral held by the System or by its agent in the System's name, and $17,882,110 was uninsured and uncollateralized. The uninsured and uncollateralized balance is primarily U.S. dollar equivalents of foreign cash held for the purpose of settling transactions.

The System's investments are categorized to give an indication of the level of risk assumed at fiscal year-end. The three categories of credit risk are:

- Category 1 includes investments that are insured or registered, or for which the securities are held by the System or its agent in the System's name.
- Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the System's name.
- Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent, but not in the System's name.

The following table summarizes the risk categories and fair values of investments held by the System as of June 30, 1999 (in thousands):

	Category 1	**Fair value**
Short-term securities:		
Repurchase agreements	$1,125	$1,125
U.S. Treasury issues	1,964	1,964
	3,089	3,089
Equity securities:		
Common stock:		
Not on securities loan	4,372,709	4,372,709
On securities loan for noncash collateral	15,452	15,452

Other:		
Not on securities loan	135,643	135,643
On securities loan for noncash collateral	4,687	4,687
	4,528,491	4,528,491
Fixed income securities:		
Mortgage-backed securities:		
Not on securities loan	1,071,075	1,071,075
On securities loan for noncash collateral	27,655	27,655
U.S. corporate bonds:		
Not on securities loan	627,908	627,908
On securities loan for noncash collateral	15,477	15,477
U.S. Government bonds:		
Not on securities loan	148,386	148,386
On securities loan for noncash collateral	63,000	63,000
Foreign bonds	449,883	449,883
Asset backed securities	202,997	202,997
	2,606,381	2,606,381
Total categorized investments	$7,137,961	$7,137,961
Investments not subject to categorization:		
Investments held by broker dealers under securities loans for cash collateral:		
Equity securities:		
Common stock		228,474
Other		69,715
Fixed income securities:		
Mortgage-backed securities		8,484
U.S. corporate bonds		18,704
U.S. Government bonds		223,543
Foreign bonds		31,881
Asset backed securities		11,587
Pooled funds and other:		
Short-term securities		437,600
Equity securities		149,125
Fixed income securities		43,487
Index funds		974,990
Real estate investments		446,240
Real estate mortgages		122,759
Real estate owned		58,285
Alternative investments		43,432
Total investments		$10,006,267

Reconciliation to investments on combined statement of plan net assets:	
Total investments	$10,006,267
Less short-term securities:	
Repurchase agreements	(1,125)
U.S. Treasury issues	(1,964)
Pooled funds and other	(437,600)
Less investments on securities loans that were sold and pending settlement; included in investment sale proceeds receivable:	
U.S. common stock	(280)
Foreign common stock	(2,046)
U.S. Government	(50,138)
Investments on combined statement of plan net assets	$9,513,114

Short-term securities and a portion of the pooled funds and other are reported as short-term investments in the accompanying combined statement of plan net assets.

Derivative investments

The System enters into various derivative investment contracts to hedge, reduce costs and enhance liquidity. As with any investment, derivative contracts are subject to various types of credit and market risks. Notably, these would include the possible inability of a counterparty to meet the terms of the contract, changes in the market value of the underlying collateral, or changes in the interest rate environment. Certain of the System's investments in derivative securities and contracts and their associated credit and market risks are described as follows:

Forward Currency Exchange Contracts - The System enters into various forward currency exchange contracts to manage exposure to changes in foreign currency exchange rates and to facilitate the settlement of foreign security transactions. A forward contract is an agreement to buy or sell a specific amount of currency at a specific delivery or maturity date for an agreed-upon price. Risks associated with such contracts include movements in the value of the foreign currency relative to the U.S. dollar and the ability of the counterparty to perform in accordance with the terms of the contract. Changes in the market value of open and closed forward contracts are recorded as net appreciation in fair value of investments in the accompanying statement of changes in plan net assets. The fair value of forward currency exchange contracts outstanding as of June 30, 1999 are as follows:

Forward currency purchases	$740,434,567
Forward currency sales	738,840,851
Unrealized gains	$ 1,593,716

Mortgage-Backed Securities - As of June 30, 1999, the fair value of mortgage-backed securities issued or backed by the U.S. Government or its agencies, or corporate issues rated AAA by at least one of the major rating agencies was $1,107,214,000. A mortgage-backed security depends on the underlying pool of mortgage loans to provide the cash flow to make principal and interest payments on the security. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. For example, if interest rates decline and homeowners refinance mortgages, thereby pre-paying the mortgages underlying these securities, the cash flows from interest payments are reduced and the value of these securities declines. Conversely, if homeowners pay on mortgages longer than anticipated, the cash flows are greater and the return on the investment would be higher than anticipated. A collateralized mortgage obligation (CMO) is a mortgage-backed security that is comprised of classes of bonds created by prioritizing the cash flows of the underlying mortgage pool. As of June 30, 1999, the fair value of CMO securities was approximately $121,516,000.

Securities lending

The System participated in a securities lending program administered by its bank custodian. Under this program, which is permissible under Chapter 88 of the Hawaii Revised Statutes, certain equity and fixed income securities of the System were lent to participating broker-dealers and banks (borrowers). In return, the System received cash, securities issued or guaranteed by the U.S. government and/or letters of credit as collateral. The System did not have the ability to pledge or sell collateral securities absent of borrower default. Borrowers were required to deliver collateral for each loan equal to: (1) in the case of loaned securities denominated in U.S. dollars or whose primary trading market was located in the U.S., 102% of the fair value of the loaned securities; and (2) in the case of loaned securities not denominated in U.S. dollars or whose primary trading market was not located in the U.S., 105% of the fair value of the loaned securities. The collateral was marked to market daily. If the fair value of the collateral fell below the minimum collateral requirements, additional collateral was provided. Securities on loan for cash collateral are presented as unclassified in the preceding schedule of custodial credit risk; securities on loan for securities collateral are classified according to the underlying security. At June 30, 1999, the System had no credit risk exposure to borrowers because the fair value of collateral held by the System exceeded the fair value of securities loaned. As of June 30, 1999, the fair value of securities loaned and associated collateral amounted to approximately $718,659,000 and $744,041,000, respectively. In addition, the bank custodian indemnified the System by agreeing to purchase replacement securities or return cash collateral in the event the borrower failed to return the loaned security or pay distributions.

The System did not impose any restrictions on the amount of loans the bank custodian made on behalf of the System. Also, the System and the borrowers maintained the right to terminate securities lending transactions on demand. As such, the maturities of the investments made with cash collateral generally did not match the maturities of the securities loans. The extent of such mismatch as of June 30, 1999 was 40 days.

Foreign investments

As of June 30, 1999, the fair value of the System's investments in foreign equity and fixed income securities are as follows:

Foreign equity securities	$1,296,951,069
Foreign fixed income securities	484,475,506
	$1,781,426,575

Note 7 – Risk management

The System 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 System is involved in various litigation and claims, including claims regarding retirement benefits, the outcome of which cannot be presently determined. In the opinion of management, the outcome of these actions will not have a material adverse effect on the System's financial position.

Property and liability insurance

The System has purchased property and liability insurance for all real estate owned from outside carriers. During the past three fiscal years, no loss settlements exceeded insurance coverages.

Workers' compensation policy

The State has a self-insured workers' compensation policy. Workers' compensation claims are paid from legislative appropriations.

Note 8 – Commitments

In the normal course of business, the System enters into commitments with associated risks. The System adheres to the same credit policies, financial administrative controls and risk limiting and monitoring procedures for these commitments as for all investments.

The System has future financial commitments of up to an additional $239,632,004 in alternative investments as of June 30, 1999.

Note 9 – Contingencies

The State of Hawaii Supreme Court ruled against the System in a class action suit filed by the retired public school principals, vice principals, and teachers whose retirement benefits were calculated using the "High 3" method of computing average final compensation. Under the terms of the court order, the System is required to recalculate monthly retirement benefits for all members of the class who are (a) school principals and vice principals collecting a retirement benefit in 1984, (b) teachers collecting a retirement benefit in 1988, and (c) members of these groups who have since retired. Not all members of the class will receive increased pension benefits. During the fiscal year ended June 30, 1999, the System made the initial retroactive benefit payments to 4,110 members of this class. As of June 30, 1999, the estimated unpaid liability is $853,000.

Exhibit A

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Combined Statement of Plan Net Assets

June 30, 1999

Assets

Cash and short-term investments (note 6):				
Cash			$	17,076,939
Short-term investments				443,190,352
				460,267,291
Receivables:				
Investment sale proceeds and other	$	422,141,936		
Accrued investment income		50,217,214		
Employer appropriations		7,968,689		
Member contributions		751,065		
				481,078,904
Investments, at fair value (note 6):				
Equity securities		4,973,478,783		
Fixed income securities		2,893,929,883		
Index funds		974,990,275		
Real estate investments		446,239,511		
Real estate mortgages		122,758,800		
Real estate owned		58,285,000		
Alternative investments		43,431,779		
				9,513,114,031
Invested securities lending collateral (note 6)				601,882,182
Equipment at cost, net of depreciation				172,143
Total assets				11,056,514,551

Liabilities

Bank overdraft (note 6)		3,447,133		
Accounts and other payables (note 9)		15,928,930		
Investment purchases payable		720,939,935		
Payable to Internal Revenue Service		8,615,297		
Due to employers		25,941,570		
Securities lending collateral (note 6)		601,882,182		
Total liabilities				1,376,755,047
Net assets held in trust for pension benefits (note 4) (a schedule of funding progress is presented at Exhibit C)			$	9,679,759,504

Commitments and contingencies (notes 6, 7, 8 and 9)

See accompanying notes to financial statements.

Exhibit B

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Statement of Changes in Plan Net Assets

Year ended June 30, 1999

Additions:		
Appropriations and contributions (note 5):		
Employers		$ 154,469,844
Members		55,702,647
Total contributions		210,172,491
Investment income:		
From investing activities		
Net appreciation in fair value of investments	$ 603,921,849	
Interest on fixed income securities	172,651,897	
Dividends on equity securities	79,652,696	
Interest and fees on real estate mortgages	12,891,806	
Interest on short-term investments	18,461,545	
Income on real estate investments	29,024,659	
Rental income	9,663,298	
Miscellaneous	1,448,046	
	927,715,796	
Less investment expenses	(26,006,325)	
Net income from investing activities		901,709,471
From securities lending activities (note 6):		
Securities lending income	31,796,077	
Less securities lending activities expenses:		
Borrower rebates	(27,921,660)	
Management fees	(774,540)	
Net income from securities lending activities		3,099,877
Total net investment income		904,809,348
Total additions		1,114,981,839
Deductions:		
Benefit payments	444,047,239	
Refunds of member contributions	39,151,493	
Administrative expenses	3,775,942	
Refunds paid to state and counties (note 4)	29,272	
Total deductions		487,003,946
Net increase		627,977,893
Net assets held in trust for pension benefits:		
Beginning of year		9,051,781,611
End of year		$ 9,679,759,504

See accompanying notes to financial statements.

Exhibit C

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Required Supplementary Information

Schedule of Funding Progress

(in thousands)

Actuarial Valuation Date		Actuarial Valuation of Assets (a)		Actuarial Accrued Liability (AAL) – Entry Age (b) *		Unfunded AAL (UAAL) (c)* = (b) - (a)		Funded Ratio (a)/(b)		Covered Payroll (d)	UAAL as a Percentage of Covered Payroll (c)/(d)
June 30, 1999	$	8,707,193	$	9,181,731	$	474,538	$	94.8%	$	2,186,499	21.7%
June 30, 1998		8,017,174		8,492,012		474,838		94.4%		2,135,945	22.2%
June 30, 1997		7,330,052		8,001,855		671,803		91.6%		2,019,268	33.3%

In January 1999, the System's Board of Trustees changed the method for calculating the actuarial value of assets in the June 30, 1997 actuarial valuation. In addition, in June 1999, the Legislature of the State of Hawaii enacted Act 100, which amends Section 88-107 of the Hawaii Revised Statutes related to the application of actuarial investment earnings in excess of the actuarial investment yield rate. The actuarial value of assets as of June 30, 1998 and 1997 has been revised to reflect these changes.

*Note: Items (b) and (c) include the unfunded liabilities related to the Early Incentive Retirement Program retirees who retired on December 31, 1994 and June 30, 1995 amounting to $39,110,800 and $62,597,400, and $84,344,100 as of June 30, 1999, 1998 and 1997, respectively.

Exhibit D

Schedule of Employer Contributions
(in thousands)

Year ended June 30		Annual Required Contribution		Actual Contribution	Percentage Contributed
1999	$	185,387	$	154,470	83.3%
1998		307,680		310,627	101.0%
1997		323,188		322,121	99.7%

Note that years previous to 1997 are not shown because such information is not available in accordance with the parameters of Governmental Accounting Standards Board Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans.*

Unaudited – see accompanying independent auditors' report.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Notes to Required Supplementary Information

June 30, 1999

The information presented in the required supplementary schedules was determined as part of the annual actuarial valuation. Additional information for the year ended June 30, 1999 as of the latest actuarial valuation follows:

Valuation date	June 30, 1999*
Actuarial cost method	Entry age normal
Amortization method	Level dollar
Remaining amortization period	The unfunded actuarial accrued liability related to the Early Incentive Retirement Program is amortized over 2 overlapping 5-year closed periods. The remaining unfunded actuarial accrued liability is amortized over a 17-year closed period.*
Asset valuation method	An expected actuarial value of assets using the assumed 8.0% rate of return is calculated. This value is adjusted by recognizing, over a four year period, the difference between the expected actuarial value of assets and the actual market value of assets. Beginning in 1999, the System shall retain 100% of the actuarial investment earnings in excess of the actuarial investment yield rate.*
Actuarial assumptions:	
Investment rate of return	8.0%
Projected salary increases	Based on the actual salary growth experience during the most recent three years for general employees, teachers, and for police, fire and corrections, which ranges from 2.4% to 5.7%.
Assumed inflation rate	4.0%
Post retirement benefit increases	2.5% (not compounded)

* The annual required contribution for the year ended June 30, 1999 was determined as part of an actuarial valuation dated June 30, 1996. The total unfunded actuarial accrued liability, including the unfunded actuarial accrued liability related to the Early Incentive Retirement Program, was amortized over a weighted average 40-year closed period and the asset valuation method was to calculate an expected actuarial value of assets using an assumed 8% rate of return adjusted by recognizing, over a two year period, the difference between the expected actuarial value of assets and the actual market value of assets. All other information is consistent with the actuarial valuation as of June 30, 1999.

Unaudited – see accompanying independent auditor's report.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Year 2000 Disclosures

Year ended June 30, 1999

YEAR 2000 STATUS

The System has conducted an inventory of computer systems and other electronic equipment that may be affected by the Year 2000 issue and that are necessary to conducting the System's operations. As of June 30, 1999, the System has assessed, remediated, tested and validated all in-house systems identified as being critical to the operations of the Employees' Retirement System.

In addition to evaluating its own systems and equipment, the System contacted investment managers, custodians, advisors, other vendors and governmental agencies that it relies on to assess their Year 2000 programs and progress. The System has no information that indicates a significant vendor or service provider may be unable to sell goods or provide services to the System as a result of the Year 2000 issue.

Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determined until the Year 2000 and thereafter. Management cannot assure that the System is or will be Year 2000 ready, that the System's remediation efforts will be successful in whole or in part, or that parties with whom the System does business will be Year 2000 ready. However, management believes that its assessment of Year 2000 readiness is valid and that the appropriate measures have been implemented to minimize disruptions to the System's operations resulting from the Year 2000.

Unaudited – see accompanying independent auditors' report.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Combining Statement of Plan Net Assets – All Trust and Agency Funds

June 30, 1999

Assets	Pension Trust Employees' Retirement System	Agency Social Security Contribution	Total
Cash and short-term investments:			
Cash	$ 16,421,975	$ 654,964	$ 17,076,939
Short-term investments	434,304,359	8,885,993	443,190,352
	450,726,334	9,540,957	460,267,291
Receivables:			
Investment sale proceeds and other	422,141,936	—	422,141,936
Accrued investment income	50,217,214	—	50,217,214
Employer appropriations	—	7,968,689	7,968,689
Member contributions	751,065	—	751,065
	473,110,215	7,968,689	481,078,904
Investments, at fair value:			
Equity securities	4,973,478,783	—	4,973,478,783
Fixed income securities	2,893,929,883	—	2,893,929,883
Index funds	974,990,275	—	974,990,275
Real estate investments	446,239,511	—	446,239,511
Real estate mortgages	122,758,800	—	122,758,800
Real estate owned	58,285,000	—	58,285,000
Alternative investments	43,431,779	—	43,431,779
	9,513,114,031	—	9,513,114,031
Invested securities lending collateral	601,882,182	—	601,882,182
Equipment at cost, net of depreciation	172,143	—	172,143
Total assets	11,039,004,905	17,509,646	11,056,514,551
Liabilities			
Bank overdraft	3,447,133	—	3,447,133
Accounts and other payables	15,928,930	—	15,928,930
Investment purchases payable	720,939,935	—	720,939,935
Payable to Internal Revenue Service	—	8,615,297	8,615,297
Due to employers	17,047,221	8,894,349	25,941,570
Securities lending collateral	601,882,182	—	601,882,182
Total liabilities	1,359,245,401	17,509,646	1,376,755,047
Net assets held in trust for pension benefits	$ 9,679,759,504	$ —	$ 9,679,759,504

See accompanying independent auditors' report.

Exhibit G

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Changes in Net Assets Held in Trust for Pension Benefits

Year ended June 30, 1999

	Pension Accumulation Fund	Annuity Savings Fund	Expense Fund	Minimum Pension Fund	Total
Additions:					
Appropriations and contributions:					
Employers	$ 154,469,700	$ —	$ —	$ 144	$ 154,469,844
Members	—	55,702,647	—	—	55,702,647
Net investment income	904,809,348	—	—	—	904,809,348
Total additions	1,059,279,048	55,702,647	—	144	1,114,981,839
Deductions:					
Benefit payments	444,047,239	—	—	—	444,047,239
Refunds of member contributions	34,696,835	4,454,658	—	—	39,151,493
Administrative expenses	—	—	3,775,942	—	3,775,942
Refunds paid to state and counties	—	—	—	29,272	29,272
Total deductions	478,744,074	4,454,658	3,775,942	29,272	487,003,946
Other changes in net assets held in trust for pension benefits:					
Transfer due to retirement of members	70,434,929	(70,434,929)	—	—	—
Transfer of interest allocation	(37,925,162)	37,925,162	—	—	—
Transfer to pay administrative expenses	(6,345,904)	—	6,345,904	—	—
Return of unexpended and unobligated funds due to savings in administrative expenses	1,249,025	—	(1,249,025)	—	—
Net increase (decrease)	607,947,862	18,738,222	1,320,937	(29,128)	627,977,893
Net assets held in trust for pension benefits:					
Beginning of year, as restated	8,168,210,337	883,457,999	84,147	29,128	9,051,781,611
End of year	$ 8,776,158,199	$ 902,196,221	$ 1,405,084	$ —	$ 9,679,759,504

See accompanying independent auditors' report.

Exhibit H

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Social Security Contribution Fund

Statement of Changes in Assets and Liabilities

Year ended June 30, 1999

Assets	July 1, 1998	Additions	Deductions	June 30, 1999
Cash	$ 72,506	$ 76,215,314	$ 75,632,856	$ 654,964
Short-term investments	6,676,696	6,230,563	4,021,266	8,885,993
Employer appropriations receivable	963,676	134,502,857	127,497,844	7,968,689
	$ 7,712,878	$ 216,948,734	$ 207,151,966	$ 17,509,646
Liabilities				
Bank overdraft	$ 525,772	$ 124,941,533	$ 125,467,305	$ —
Payable to Internal Revenue Service	4,643,792	128,385,582	124,414,077	8,615,297
Due to employers	2,543,314	134,737,668	128,386,633	8,894,349
	$ 7,712,878	$ 388,064,783	$ 378,268,015	$ 17,509,646

See accompanying independent auditors' report.

Exhibit I

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Supplemental Schedule of Administrative Expenses

Year ended June 30, 1999

Salaries and wages	$	2,168,035
Fringe benefits		558,025
Automated data processing project		280,548
Legal		140,341
Auditing and tax consulting		115,625
Medical board		114,504
Postage		86,701
Actuarial		77,000
Repairs and maintenance		66,378
Office supplies		40,848
Office equipment		27,350
Travel		16,057
Telephone		13,740
Printing and binding		11,779
Microfilm		11,473
Rental of equipment		8,821
Rental of office space		7,142
Armored car service		4,434
Disability hearing expenses		4,299
Miscellaneous		22,842
	$	3,775,942

See accompanying independent auditors' report.

Exhibit J

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Supplemental Schedule of Investment and
Securities Lending Activities Expenses

Year ended June 30, 1999

Investment expenses:		
Investment manager/advisor fees	$	21,546,951
Bank custodian fees		126,279
Operating expenses – rental		4,302,891
Other investment expenses		30,204
Total investment expenses		26,006,325
Securities lending activities expenses:		
Borrower rebates		27,921,660
Management fees		774,540
Total securities lending activities expenses		28,696,200
	$	54,702,525

See accompanying independent auditors' report.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Employees' Retirement System of the State of Hawaii and the Department of Budget and Finance on March 10, 2000. A copy of the transmittal letter to the retirement system is included as Attachment 1. The responses of the Employees' Retirement System of the State of Hawaii and the Department of Budget and Finance are included as Attachment 2 and 3, respectively.

The Department of Budget and Finance generally concurs with our findings and responded that it will work with the appropriate state agencies to monitor the collection of pension assessments. However, the retirement system agrees with some of the findings, and disagrees with others. It stated that "many of the criticisms cited in the report were in areas in which we had little control."

The retirement system acknowledges that the bank custodian and securities lending contracts "were not signed on time." They state that the system's assets were not at risk because banking laws imposed the same standards on Bankers Trust to act as a fiduciary and custodian of the system's assets.

We disagree. The unsigned agreements seriously jeopardized the system's accountability over these investments. A properly executed contract is essential to ensure that the type and scope of services are agreed upon and the roles and responsibilities of both the consultant and the retirement system are clearly delineated. It is essential that such contracts be properly executed prior to any services being rendered.

The retirement system also reported that the attorney general had more than 65 days to review the bank custodian contract. It noted that a memorandum was sent to the attorney general on July 31, 1996 to review and develop contracts for the custodial banking and securities lending contracts. However, this memorandum included the old contracts and indicated that the solicitation process would start by August 20, 1996. The recommendation to hire Bankers Trust did not occur until December 9, 1996, more than three months after the anticipated start of the solicitation process. The specific provisions negotiated during this solicitation process were sent to the attorney general for review on December 24, 1996.

The retirement system also disagreed with our finding that management has not adequately acted on nonperformance by the bank custodian and has not enforced remedies for noncompliance. Yet, the system acknowledges that "reconciliations were not completed on time." It states that the system's assets were not jeopardized because staff and investment managers performed these reconciliations. However, we found that the bank custodian did not perform its contractually required reconciliations, and the retirement system did not enforce these contract provisions. Even when investment managers performed these reconciliations, staff still uncovered errors that should have been identified by the reconciliation process.

The retirement system also states that the $5 million recording error was not an error. We disagree. The bank did not submit the June investment reports until the end of July. This gives the bank ample time to record this transaction in June on a trade date basis. Furthermore, the retirement system recorded the $5 million as a June 30, 1999 transaction.

In response to our point that the retirement system waived a penalty for nonperformance by the bank custodian, the retirement system stated that waiver of the discount penalty was made by staff and that staff also negotiated additional reporting and account structure requirements that were not included in the contract. This is troublesome because the retirement system is indicating that staff are making new key contract decisions outside the contract, which in turn raises the question of whether the new terms were reviewed and approved by the administrator, board, and attorney general.

The retirement system acknowledges the contract management problems with the data purification project, but disagrees with our finding that the project has not improved the pension benefits process. It states that data from the project has been used to prepare retirement estimates, finalize retirees' pension, and process the early incentive retirees in 1994 and 1995. However, we found that the system has not changed the process to verify the data used in processing pension benefits. Staff continue to manually verify pension data submitted by departments and produced by the pension benefits system. This was confirmed by our discussions with key management and staff involved in the process.

The retirement system did not disagree with our finding on its lateness in finalizing retiree pensions. However, it did provide an explanation for the delays in finalizing pension benefits to more than 1,100 retirees.

Finally, the retirement system agreed with our finding that it owes the State $17 million in excess employer contributions, and that the system's unfunded liability increased because of recent legislation.

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

March 10, 2000

COPY

Ms. Koren K. Kubota, Chair
Board of Trustees
Employees' Retirement System
City Financial Tower
201 Merchant Street, Suite 1400
Honolulu, Hawaii 96813

Dear Ms. Kubota:

Enclosed for your information are 8 copies, numbered 6 to 13 of our draft report, *Financial Audit of the Employees' Retirement System of the State of Hawaii*. Please distribute the copies to the members of the board and to the administrator. A copy of the draft is being sent to the director of finance. We ask that you telephone us by Tuesday, March 14, 2000, 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 Monday, March 20, 2000.

The Director of 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

BENJAMIN J. CAYETANO
GOVERNOR

STATE OF HAWAII

EMPLOYEES' RETIREMENT SYSTEM

March 22, 2000

RECEIVED
MAR 22 4 38 PM '00
OFC. OF THE AUDITOR
STATE OF HAWAII

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

Dear Ms. Higa:

Thank you for the opportunity to respond to the draft copy of the Audit of the Hawaii Employees' Retirement System (System). We are proud of our staff's performance and their unwavering commitment to excellence. As reported in Chapter 3, KPMG, the independent certified public accounting firm, believed that none of the reportable conditions were material weaknesses. The report reaffirms the System's selection for the prestigious national award, the Certificate of Achievement for Excellence in Financial Reporting issued by the Government Finance Officers Association of the United States of America and Canada for nine consecutive years.

The audited period FY 1998-1999 was not representative of our normal operations. The settlement payments for the Teachers' and Principals' class action lawsuits overshadowed other facets of our operations. Recalculating pension amounts and processing claims related to the lawsuit were our highest priorities. Retirees had been waiting for many years for their settlements. The reallocation of resources to these priorities contributed to the backlog in completing final pension payment calculations. Despite having to stretch our resources, basic services were provided and our employees won the Department of Budget and Finance's Team Award for their exemplary performance in processing the payments to the retired teachers and principals so efficiently and expeditiously.

Many of the criticisms cited in the report were in areas in which we had little control. We will continue to advocate for legislative action to authorize the System to contract legal services for highly specialized investment transactions to reduce delays in contract preparation and execution. We will also continue to request the Governor's and Mayors' assistance in securing the audited sick leave records to ensure timely finalizing of pension payments. And we will work with the Department of Budget and Finance (B&F) to secure 100% funding of future appropriations to the System.

City Financial Tower
201 Merchant Street, Suite 1400 • Honolulu, Hawaii 96813-2980
Telephone (808) 586-1660 • Fax (808) 586-1677

We would like to respond to your Findings as follows:

FINDING #1:

DELAYS IN EXECUTING CONTRACTS FOR BANK CUSTODIAN AND SECURITIES LENDING SERVICES PLACED ASSETS AT RISK AND RESULTED IN LOST INVESTMENT INCOME.

DISCUSSION:

(a) "Services performed prior to execution of bank custodian contract places members' moneys at risk."

The System's assets were not at risk. Although the contracts were not signed on time, banking laws imposed the same standards on Bankers Trust to act as a fiduciary and custodian of our members' assets.

Aborting the comprehensive plan that was developed to insure a smooth transition period would have resulted in a greater risk to our assets. Transition of the $7.5 billion investment portfolio involved a significant amount of planning and coordination that included:

- *parallel accounting of securities transactions between three banks in the period preceding changing the custodial bank,*
- *preparing domestic and foreign investment managers to trade on the new bank custodian's computer system(s),*
- *recalling all of the loaned securities, and*
- *training System staff to use the new bank's information system.*

Effective on the date of transfer of assets to Bankers Trust, the System's staff and investment managers had on-line access to all asset and transaction activity and monthly audited statements for each account. There was continual disclosure of current information to the System's staff and investment managers to ensure that all assets were accounted for.

(b) "The System allowed the Attorney General's (AG) office only 65 days to review a five-year contract."

This is incorrect. On July 31, 1996, five months prior to the expiration of the existing contracts, a memo was sent to the Attorney General's(AG) office requesting that they begin to review and develop contracts for custodial banking and securities lending services. Copies of the current five-year master custodial and securities lending contracts and sample contracts from two other states were attached to facilitate the review. A two-month extension of the contracts through February 28, 1997 gave the

AG's office 212 days to complete the review. The AG's office eventually took 337 days to review and finalize the contracts, forcing the System to work with an unsigned agreement for over four months. We believe that this is an unreasonably lengthy response time.

In the end, the final custody and securities lending contracts incorporated a significant portion of the previous contracts.

The law designates the Office of the Attorney General as "the legal adviser for the ERS." Contract procurement falls under its jurisdiction and our problems with contract execution are a direct result of the System's disenfranchisement in 1995 when the System's authorization to hire outside legal counsel was revoked by the Legislature.

Prompted by delays in obtaining timely legal counsel for the custodial bank contract and the sale of the Waikele Commercial Center for over $200 million, H.B.1815 was amended by the 1997 State Senate to address this problem. Lawmakers recognized the need to grant the System more control and flexibility for its legal work by empowering the Board of Trustees to retain outside legal counsel for investment matters. In the Senate Committee on Ways and Means Report to the Senate, the Committee reported " . . . that expeditious legal counsel is necessary if a large, sophisticated entity such as the (ERS), is to thrive in today's global marketplace, especially with the proliferation of high-speed telecommunication and transportation systems that effectively prevent the sun from setting on the entity's overseas holdings and assets. Your Committee also finds that an entity such as the Employees' Retirement System, needs expert business advice to ensure that its investments are being managed wisely and carefully guarded from the turbulent economic events befalling different regions of the world."

H.B. 1815 was vetoed by the Administration.

In response to an inquiry by the Senate Committee on Ways and Means, the System wrote in a letter dated April 27, 1998, "It is the intent of the ERS to continue to utilize the services of the Deputy Attorney General currently assigned to the Board of Trustees for disability cases, AG opinions, Board meetings, etc. The purpose of allowing the System to hire its own legal counsel is specifically for investment purposes. From time to time, the System enters into legal agreements and/or contracts regarding investments and it is necessary to have someone who is familiar with the kinds of investments that the System is involved in to review and to approve these agreements."

(c) "Untimely securities lending contract results in approximately $1 million of lost income"

As a matter of bank policy, Bankers Trust Company will not engage in securities lending activity on behalf of its clients without the express written authorization of such clients in order to adequately define the role of the agent lender and protect their clients. The risks inherent in a securities lending program are greater than a general custody agreement because of third party agent lenders. The delay in the contract review and preparation by the Office of the Attorney General translated into $200,000 in lost securities income each month.

RESPONSE:

The System is being criticized for matters beyond its control. We will continue to advocate for legislation to enable the System to hire specialized legal counsel on investment matters to eliminate the delays in contract review and execution.

FINDING #2:

MANAGEMENT HAS NOT ADEQUATELY ACTED ON NONPERFORMANCE BY THE BANK CUSTODIAN AND HAS NOT ENFORCED CERTAIN REMEDIES FOR NONCOMPLIANCE.

MANAGEMENT'S FAILURE TO ENFORCE THE INVESTMENT RECONCILIATION BY THE BANK CUSTODIAN IN A TIMELY MANNER JEOPARDIZES THE SAFEGUARDING OF MEMBERS' MONEYS.

DISCUSSION:

(a) Although the reconciliations were not completed on time, the members' moneys and the System's assets were not jeopardized when the System's internal control and mitigating facts are considered.

As pointed out by the report, the System's staff performed the reconciliations to ensure the assets were properly recorded. In addition, the System's investment managers, as fiduciaries, are also required to reconcile the custodian bank's reports.

There were no instances of lost assets. At no time were Board meetings or presentations delayed or postponed nor were decision-making capabilities impeded due to late statements.

(b) *The $5 million "error" cited in the report was not an error.*

The $5 million transaction in question is a "To Be Announced" (TBA) Fannie Mae security. TBAs are securities that have not been issued on the trade date and the specific mortgage pools are "to be announced" at a later date. Unlike the majority of securities that are recorded on trade date, TBAs are not recorded until more information is available. As such, the custodian bank will not record the transaction until the manager receives the information and affirms the trade with the bank. The manager received the information on July 20, 1999 and Bankers Trust properly recorded the settlement of the TBA on July 23, 1999.

As a routine procedure, and especially at fiscal year end, staff reviews subsequent months' transactions to ensure transactions are recorded in the proper period. As stated earlier, the $5 million transaction, although recorded in July, was identified and properly recorded as a June transaction for financial reporting purposes.

(c) *Staff monitored the custodian bank's performance on a regular basis and regularly scheduled meetings with the custodian bank to rectify concerns. Possible termination of the contract was discussed but delayed for the following reasons:*

- *The European Monetary Unit conversion of numerous European currencies to a single currency unit on January 1, 1999, was a major concern and, therefore, it was inappropriate to transition to a new bank at that time.*

- *The Deutsche Bank acquisition of Bankers Trust in June 1999 potentially offered the System enhanced services. Seventy-five thousand dollars ($75,000) was also given to the System as part of staff's negotiation of the original contract.*

- *With the "Y2K" programming issue, the System, like many other financial institutions, believed that it would not be prudent to undertake any major banking change until the "dust" settled after December 31, 1999.*

At the October 1999 meeting of the System's Board of Trustees, senior bank representatives presented a plan of action to address all deficiencies and improve its performance under the contract.

The Board wanted to give Bankers Trust an opportunity to rectify the concerns before making a change. Bankers Trust complied with Board demands and addressed all concerns by the end of January 2000.

(d) *Section 21(a) 4 of the contract allows for price adjustment if the parties mutually agree. As indicated in the LA report, the System's staff and investment managers were partially responsible for the delays.*

The report does not point out that staff had negotiated additional reporting and account structure requirements that were not included in the contract. This added value far exceeds the discount penalty waived by staff.

The System chose not to enforce a provision as an act of discretion; not a neglect of fiduciary duty. System staff initiatives requiring timely investment manager reconciliations and audited monthly statements have resulted in the bank custodian's timely delivery of the reports since September 1999.

RESPONSE:

The System has been monitoring the custodian bank's performance and advising the Board of major problems.

The Report did not acknowledge the excellent job by the System in negotiating the contract with Bankers Trust. Approximately $7 million is being added to the System's bottom line over the 5-year contract period through an increased share of securities lending revenues, reduced custodial expenses, and reduced short-term investment management expenses.

FINDING #3:

THE SYSTEM OWES THE STATE $17 MILLION

DISCUSSION:

The System's management was waiting for the U.S. Department of Health and Human Services' (DHHS) approval of the Department of Budget and Finance's (B&F) consultant's report for FY 1996-97. Review of the B&F consultant's report by the System's staff revealed several errors.

As a fiduciary of the Pension Accumulation Fund, it would have been irresponsible to return funds without first determining the reason for the discrepancies in the B&F consultant's report. The B&F consultant subsequently concurred that discrepancies did exist and the methodology will be re-evaluated by the B&F consultant and DHHS.

Over $6 million of excess contributions were returned to the State on October 18, 1999. Any excess contributions collected during FY 1998 and FY 1999 will be returned to the State as soon as DHHS approves the B&F's consultant's reports.

RESPONSE:

The System is being criticized for following the methodology prescribed by the Federal government.

We concur with the Auditor's recommendation to initiate efforts to appropriate 100% of the employer contributions, including federal/special funds. We will also request that the Social Security funds be transferred to B&F, as the concept of management of this account is similar to the Pension Accumulation contributions.

FINDING #4:

DATA PURIFICATION PROJECT (DPP) WAS A WASTE OF RESOURCES
MANAGEMENT FAILED TO RETAIN OWNERSHIP RIGHTS TO SOFTWARE

DISCUSSION:

(a) *The System is the sole historical repository of semi-monthly payroll and personnel transactions for its members. At retirement, this data is used to determine service credit, which is an integral part of the calculation of a member's lifetime pension. Service credit is also the most complex component of the benefit formula used to calculate a member's lifetime pension.*

The System recognized the need to establish a "clean" or purified service credit database as the foundation for future System enhancements and ultimately, improved service for its members. A Request For Proposal was issued to contract a consulting firm to extract and "purify" the membership data from microfiche records dating from 1958. Although a number of firms expressed interest, only one firm submitted a bid.

This monumental effort involved researching, collecting and keypunching payroll and personnel data; calculating membership service credit and deficient member contributions; and determining the beneficiaries of Contributory Plan members. It was complicated by the sheer volume of payroll and personnel transactions (over 13 million); changes in the payroll and personnel computer systems of the State *and County governments over the years; non-standardized reporting systems among the different entities; numerous retirement-related data errors in the State and County's payroll and personnel transactions; and the number of retirement benefit enhancements that have occurred from 1958 to 1999. Over 463,000 corrections were electronically accomplished by this project.*

Prior to the successful completion of DPP, the determination of membership service credit was an intensive, manual effort involving perusal, analysis, and interpretation of monthly payroll and personnel transactions. The completion of this extremely challenging and time-consuming project with its many unexpected problems is a tribute to the perseverance and dedication of the consultant's and System's staff.

For the first time ever, Membership Statements reporting service credit were sent to over 63,000 active and inactive vested members in January 2000. Less than ten percent of our members have questions on the membership service credit data due to the sophisticated computer programs developed by the consultant. It may take our special teams two years to research and correct discrepancies because of the need to contact members' personnel and payroll agencies for verification of historical data.

The payroll and personnel data will continue to be "purified" utilizing these computer programs on an annual basis. Member Statements will also be generated annually providing our members a current, verifiable account of their service credit and other information from their accounts like beneficiary designations, birth date, address and account balance.

Forty-two (42) years of membership service credit data is now stored in a single database whereas staff had to previously access various sources of data – microfilm, fiche, CD, paper documents, and the WANG computer system to gather the members' complete records. This "clean" historical data will be transferred into the new Retirement Benefit Computer System that is currently being developed. The System has become a valuable repository of an employee's work history as personnel and payroll departments purge their files. Providing timely retirement estimates, annual member statements, responding to service credit inquiries and finalizing retirees' pensions can now be accomplished more quickly and efficiently. By the end of 2002, members will be able to generate their own computerized retirement estimates under various "what if" scenarios through the Internet.

This project is like the construction of a house. If the house is not completed by the expected target date, does that mean that it's been a waste of money as indicated in the Audit Report? We disagree with that conclusion. This effort enabled vendors to submit a much lower bid proposal for our new computer and *office automation systems. The Report also fails to disclose that computerized worksheets containing the pre-1989 service credit data from the Data Purification Project have been used extensively to prepare thousands of retirement estimates and to finalize retirees' pensions. It would have been impossible to cope with the significant workload of the 1994 and 1995 Early Incentive Retirement Programs without utilizing the worksheets generated from the DPP.*

The true benefit of this project has not yet been fully realized. Currently, its worth cannot be tangibly measured. In the future, the purified data through June 1999 and the annual purification process will enable the System to more accurately and efficiently provide retirement estimates and finalize pension benefits for its members. Its value will not diminish as members retire but be perpetuated for all future members of the System.

(b) *The Audit Report states that management did not foresee the need to include a clause in the contract to specify that the software will belong to the System upon completion of the project. This is not correct.*

When the Data Purification Project was put out to bid, there was a question as to whether a consulting firm could retain ownership rights over any software program it developed. This would enable a firm to put in a more competitive bid since it could then consider the Hawaii project as an investment and use the software for other data purification projects in the country. Since the System's purpose was to secure "clean" historical data and we did not intend to reuse the consultant's software, we had no objections. We intended to use our internally developed system to process future payroll and personnel transactions. Without this concession, there would have been no interested vendor willing to submit a bid within the amount appropriated for this project. It was a sound business decision by the System's management.

Further, when Mercer, the original contractor, completed Phase I, they had no desire to continue work on the project. They agreed to give the software rights on the Hawaii project to Systecon, their subcontractor who developed the programs, at no cost to the System. It was a gesture of goodwill on their part to end a very difficult project.

RESPONSE:

Contrary to the report finding, we firmly believe that DPP has improved the benefit calculation process. We concur with the Auditor's recommendations regarding contract administration and have taken appropriate corrective measures.

FINDING #5:

DELAYS IN FINALIZING PENSIONS

DISCUSSION:

In FY 1999, we had 1,175 new retirees, prepared 3,457 retirement estimates, and finalized the benefits for 751 retirees. There were 1,143 retirees on estimated pensions on June 30, 1999.

The System's goal is to finalize a retiree's pension within 6-9 months of retirement. One of the reasons that the average time to finalize a retiree's pension increased to over one year was the delay in receiving audited vacation and unused sick leave data from state departments. Another reason was the delay in receiving responses to our inquiries for missing personnel or payroll data, which may affect the retiree's pension. When we are unable to secure this information from the payroll or personnel offices, a memo is sent to the State or County department head. If that measure fails, we then seek the assistance of the Governor, County Mayors, or Board Chairs.

For example, on June 4, 1999, we wrote to a Board Chairperson expressing our concern on the growing number of unaudited vacation and sick leave records. We were waiting for the leave records for 165 retirees from that department and some retirees' leave records were not audited or missing since 1993. Although the department had an extremely heavy workload due to the need to calculate and process retroactive pay increases to comply with union agreements, they hired two additional temporary employees to assist in clearing the backlog. Other employees not on their payroll staff were also trained to audit the leave records and worked overtime to help clear the backlog. The department did a good job to address this problem.

The average time to finalize the retirees' pensions also increased because the System's resources were reallocated to:

- *Recalculate over 5,000 retired principals' and teacher's pensions due to an adverse Supreme Court decision on two class action lawsuits. In 1998, we had to spend over 10,000 hours of staff time to extract membership records from microfiche, recalculate the retiree's monthly pension based on the Court's ruling, allocate attorney fees, and determine the retroactive payment amount. In 1999, over $4.5 million in additional pension benefits were paid to over 4,000 principals and teachers who retired after 1969.*

- *Prepare for similar claims filed by 1,300 retired professors and other retirees who previously worked on a 9-, 10-, and 11-month schedule.*

- *Conduct more private individual counseling sessions beginning in January 1999. For the prior four and half years, group retirement filing sessions were conducted due to the significant workload associated with the 1994 and 1995 Early Retirement Incentive programs. More time was dedicated to retirement counseling since members must make life-long decisions.*

RESPONSE:

The System is being criticized for situations over which we have little control. Staff has done a commendable job coping under difficult circumstances. We will continue to place a high priority on finalizing the retirees' pensions on a timely basis.

After handling the large number of State and County employees retiring in December 1999, a special team of retirement claims examiners and technicians was established in January 2000 to focus on the backlog. The recently installed Membership Service Credit database, a product of the Data Purification Project, will facilitate this effort.

The Department of Accounting and General Services is now developing a Time and Attendance Computer System to automate the accounting of employees' vacation and sick leave credits. The successful completion of this project will help address some of the long-standing problems encountered by the System.

FINDING #6:

UNFUNDED ACTUARIAL ACCRUED LIABILITY

DISCUSSION:

The Auditor noted that Act 100 was detrimental to the System's unfunded actuarial accrued liability and that it would increase future contributions from the State and Counties.

The Board communicated the same concerns by mailing an informational letter to all of the System's 89,000 members and retirees in September 1999.

RESPONSE:

We wholly concur with the Auditor's findings and recommendation regarding the 1999 Legislature's diversion of the System's investment earnings.

CONCLUSION:

Your audit team's points are well taken and immediate action, within our power, will be taken to rectify any discrepancies. Thank you for allowing us to address and clarify the issues in the Findings of your report. We will continue to strive for excellence. We are forever mindful of our fiduciary responsibilities to our members, retirees, and beneficiaries.

Yours truly,

Koren K. Dreher
Chair of the Board

ATTACHMENT 3

BENJAMIN J. CAYETANO
GOVERNOR

NEAL MIYAHIRA
DIRECTOR

[redacted]

WAYNE H. KIMURA
DEPUTY DIRECTOR

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

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

March 20, 2000

RECEIVED
MAR 20 10 51 AM '00
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. Higa:

Thank you for allowing me to comment on your report, "Financial Audit of the Employees' Retirement System of the State of Hawaii." As mentioned in your report, the assessment rate is based on budgeted requirements compared with actual assessments, but with a two-year lag.

As recommended in your report, we will work with the appropriate State agencies to monitor the collection of pension assessments to assure the accuracy of the assessments and collections.

Aloha,

NEAL MIYAHIRA
Director of Finance

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