STATE OF WISCONSIN
Legislative Audit Bureau

22 E. Mifflin St., Ste. 500
Madison, Wisconsin 53703
(608) 266-2818
Fax (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

Janice Mueller
State Auditor

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Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

We have completed an annual financial audit of the Department of Employee Trust Funds, as requested by the Department and to fulfill our audit requirements under s. 13.94(1)(dd), Wis. Stats. The audit covered calendar year 2003. The statements and our unqualified opinion on them are included in the Department's recently issued financial report, which provides information on the financial position and activity of various benefit programs available to public employees.

Most of the Department's programs reported positive financial results in 2003. The State's issuance of appropriation bonds at the end of 2003 to finance payment of its liabilities for the Wisconsin Retirement System (WRS) and the Accumulated Sick Leave Conversion Credit program significantly improved the financial position of both of these programs. However, employers have experienced recent increases in WRS contribution rates as a result of investment experience and benefit changes. The maturation of the WRS presents challenges for management of the system in the future.

In 2002, the Department began work on a new benefit payment system. However, after experiencing ongoing difficulties and delays in the project and incurring $3.9 million in costs, the Department terminated contracts for the development of the new system in 2004. Subsequently, it contracted with another consulting firm, at a contract amount of $198,000, to assess the project. Several contributing factors were identified, including inadequate project management by the Department, insufficient technical skills by the project team, and failure by an external project monitoring firm to complete its intended role. In February 2005, the Department contracted with a new firm, at a contract amount of $4.5 million, to implement the new payment system incrementally.

Finally, accompanying this letter is a management letter we provided to the Department, which includes an auditor's report on internal control and compliance, as required by *Government Auditing Standards.* We did not identify any control or compliance concerns required to be reported under these standards.

We appreciate the courtesy and cooperation extended to us by the Department's staff during our audit.

Sincerely,

Janice Mueller

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State Auditor

JM/DA/bm

Enclosure

DEPARTMENT OF EMPLOYEE TRUST FUNDS

The Department of Employee Trust Funds is responsible for administering the Wisconsin Retirement System (WRS) and several other programs that provide retirement, disability, health, and other benefits to participants who are current and retired employees of state and local governments. The benefit programs are funded primarily through employer and employee contributions and investment returns. Most programs reported positive net results in their financial activities during 2003. The State issued bonds in 2003 to finance the payment of its liabilities for the WRS and the Accumulated Sick Leave Conversion Credit program, which significantly improved the financial status of both of these programs.

In administering the benefit programs, the Department is dependent on complex computerized systems. In 2003, the Department experienced major problems with the development of a new benefit payment system and terminated contracts for the project. After going through a process to evaluate the problems of the system project, the Department recently contracted with another firm to begin a restructured project to address its aging benefit payment system.

Wisconsin Retirement System

With net assets of $62.1 billion at the end of 2003, the WRS is the largest program administered by the Department. Approximately 512,000 current and former employees of state agencies, school districts, and local governments in Wisconsin participate in the WRS. Its assets are managed by the State of Wisconsin Investment Board through two investment funds:

- the Fixed Retirement Investment Trust Fund (Fixed Fund)—a diversified, balanced portfolio that funds all or part of the retirement benefits for beneficiaries; and

- the Variable Retirement Investment Trust Fund (Variable Fund)—established for participants who are interested in taking a higher degree of risk by increasing their investment in equities for potentially higher long-term returns.

Investment returns and payment of the State’s pension liabilities have significantly affected the financial position and operations of the WRS in recent years. Based on various measurements, the WRS is generally considered a well-funded plan. However, employers have experienced recent increases in contribution rates, and the maturation of the system presents challenges for its future management.

Effect of Recent Investment Returns

The WRS is funded by three primary sources: employee contributions, employer contributions, and investment earnings. Investment income represents a significant, although variable, funding source. Both the Fixed Fund and the Variable Fund earned double-digit investment returns for five consecutive years in the late 1990s, as shown in Table 1. However, a market downturn in the second half of 2000 resulted in negative returns for both funds during 2000, 2001, and 2002. A rebound in the markets during 2003 returned the funds to double-digit returns that were among the highest in the last 20 years.

Table 1

Wisconsin Retirement System Annual Returns
(For Years Ending December 31)

Year	Fixed Fund Annual Return	Variable Fund Annual Return
1995	23.1%	25.6%
1996	14.4	19.8
1997	17.2	21.6
1998	14.6	17.5
1999	15.7	27.8
2000	(0.8)	(7.2)
2001	(2.3)	(8.3)
2002	(8.8)	(21.9)
2003	24.2	32.7
2004	12.8	12.7

In valuing assets in the Fixed Fund for funding purposes, an actuary hired by the Department uses a valuation method that smoothes the recognition of investment gains and losses. Use of a smoothing mechanism to moderate the effects of market volatility is a common practice among public pension funds. Wisconsin statutes have specified the actuarial asset valuation method for the Fixed Fund since 1975, and changes to the asset valuation method that provide for faster recognition of investment performance were enacted in 1999 Wisconsin Act 11.

From 1975 through 1999, statutes required that all realized and unrealized investment gains and losses in the Fixed Fund be accumulated in a transaction amortization account, with 20.0 percent of the year-end balance in the account recognized as income for actuarial and funding purposes. With the strong markets of the second half of the 1990s, the transaction amortization account grew significantly, from $2.4 billion at the end of 1994 to $13.9 billion at the end of 1999.

1999 Wisconsin Act 11 made several changes to the WRS, including changes to the Fixed Fund's asset valuation method. Act 11 eliminated the transaction amortization account over a five-year period and established a new asset valuation method, effective January 1, 2000. It directed a one-time transfer of $4.0 billion from the transaction amortization account, effective December 31, 1999, to help fund benefit improvements included in Act 11. Act 11 also required that 20.0 percent, or approximately $2.0 billion, of the remaining transaction amortization account balance be recognized as income annually from 2000 through 2004.

To replace the transaction amortization account, Act 11 established a market recognition account and required that:

- all investment income, including interest, dividends, and realized and unrealized gains and losses, be credited to the market recognition account;

- income equal to the actuarially assumed investment return rate be recognized; and

- the difference between assumed and actual investment income be recognized equally over five years.

The effect of negative investment returns from 2000 through 2002 was buffered by Act 11's provision that the market recognition account distribute an amount equal to the assumed investment return rate, as well as by the phase-out of the transaction amortization account. As a result, while actual investment earnings were negative from 2000 through 2002, the effective rates that were credited to Fixed Fund participant accounts were positive. For example, a 5.0 percent effective rate was credited to participant accounts for 2002, although the actual investment return for the Fixed Fund was -8.8 percent. However, as investment earnings rebounded for 2003 and 2004, the effective rates credited to participant accounts were less than actual returns, due to the buildup of past negative earnings that continue to flow through the market recognition account. For example, a 7.4 percent effective rate was credited to participant accounts for 2003, even though the actual investment returns were 24.2 percent.

The effect of the Fixed Fund's negative earnings on post-retirement adjustments to retiree benefits has been more rapid. After a post-retirement adjustment rate of 17.1 percent was paid in 2000 (based on earnings in 1999), the rate decreased to 5.7 percent paid in 2001 and 0.0 percent paid in 2003. With the rebound of investment earnings for 2003, an adjustment of 1.4 percent was in paid in 2004 after statutes were changed under 2003 Wisconsin Act 153, which allowed the Department to pay a positive or negative adjustment if the annual calculation process resulted in at least a 0.5 percent increase or decrease. Previously, statutes had allowed post-retirement adjustments only if sufficient funds were available to provide for an increase of 2.0 percent or more.

Liquidation of Employers' Pension Liabilities

A prior service pension liability is typically created for any local government employer that joins the WRS and opts to provide benefits for services already provided by its employees. Similarly, a prior service liability is created or increased for employers when the Legislature enacts benefit improvements that relate to services already provided. Annually, employers are assessed interest at the assumed investment return rate, which is currently 7.8 percent, for outstanding balances.

In light of lower interest rates in recent years, several employers, including the State, borrowed funds to finance the payment of part or all of their outstanding pension liabilities. From 2001 to the end of 2003, the WRS' total unfunded prior service liability decreased from $2.1 billion to $0.5 billion. Approximately $705 million of the decrease was attributable to the State's payment of its liability as of the begining of 2003. In addition, more than 250 local employers also made voluntary payments, totaling more than $500 million, to reduce their prior service liability.

As authorized by 2003 Wisconsin Acts 33 and 84, the State issued $1.8 billion in General Fund appropriation bonds in 2003 to finance payment of its unfunded pension liability and an unfunded accrued liability in the Accumulated Sick Leave Conversion Credit program, which allows retired state employees to use unused sick leave balances to pay health insurance premiums. The State's payment of the principal and interest on the appropriation bonds is subject to annual appropriation by the Legislature. While the bonds are not considered general obligations of the State, the Legislature recognized a moral obligation to make the annual appropriation. In addition to expected net interest savings on the pension liability, the bonding was structured to help address the State's budget difficulties by initially requiring the payment of interest only, and delaying principal payments until at least fiscal year (FY) 2006-07.

Funding Progress

The ultimate funding goal for the WRS is to have sufficient resources available to pay benefits as they are owed to participants. To meet that goal, the Department works with an actuary to estimate the amount of obligations that will be owed to current retirees and current employees and to implement a plan that accumulates the needed resources in an orderly fashion.

The funding progress of public retirement systems is often measured in two different ways. First, a standard measure prescribed by governmental accounting standards is a ratio of the actuary's valuation of assets accumulated to pay obligations for services already rendered by present and future retirees to the actuary's estimated value of those obligations. The difference between these two amounts represents the prior service liability and the ultimate goal is to steadily increase the ratio to 100.0 percent over time. The WRS has made significant progress in achieving that goal. Its actuarial value-based funded ratio has increased from 92.9 percent at the end of 1994 to 99.2 percent at the end of 2003. As the State and several other participating employers liquidated their prior service liabilities, the ratio improved significantly at the end of 2002 and 2003.

A second method, which more closely reflects the effects of the markets on the funded status, compares the market value of assets, as reported for financial reporting purposes, to estimated obligations. This ratio typically will exhibit more variation than the actuarial-based ratio, which has been smoothed for investment returns. For example, the WRS's market value-based ratio decreased from 122.2 percent at the end of 1999 to 83.9 percent at the end of 2002 because of the down markets during that period. The ratio increased to 97.8 percent at the end of 2003 because of the improvement in the markets during that year. Under both funding measurement methods, the WRS is generally considered a well-funded program.

Contribution Rates

Another important measure of the success of the WRS's funding plan is the stability of contribution rates that are assessed on employers' payrolls. Maintaining relatively stable contribution rates is important to system employers and to their ability to budget and fund employee retirement obligations. Combined employer and employee contribution rates for general employees and teachers, the largest category of participants in the WRS, have ranged from 9.0 percent to 11.6 percent over the last ten years, as shown in Table 2.

Table 2

Contribution Rates[1] for General Employees and Teachers

Year	Contribution Rates[1]
1996	11.6%
1997	11.4
1998	11.0
1999	10.2
2000	9.6
2001	9.0
2002	9.0
2003	9.4
2004	9.8
2005	10.2

[1] The rates include combined contribution rates for employers and employees because most employers pay the employee contributions. Employee contribution rates, which are set by statute, are 5.0 percent for general employees and teachers. The employer contributions are determined annually based on actuarial analysis. The rates do not include contribution rates for prior service liabilities, which vary by employer.

The changes in rates since 1996 have been affected by both investment experience and benefit changes. Strong investment performance in the late 1990s contributed to a steady decline in contribution rates from 11.6 percent in 1996 to 9.0 percent in 2001 and 2002. Contribution rates have increased since that time, with a contribution rate of 10.2 percent in effect for 2005. The increases in contribution rates in recent years are largely a result of the enactment of several benefit improvement provisions in 1999 Wisconsin Act 11 and of investment losses in recent years that continue to flow through the market recognition account.

Every three years, the actuary hired by the Department compares actual experience to actuarial assumptions and considers other factors that may affect the assumptions in the future. In the most recent three-year study, which covered 2000, 2001, and 2002, the actuary recommended changes to several assumptions, including rates of retirement and mortality, that contributed to the increase in the contribution rate in 2005.

Future Implications

The continued maturation of the WRS as the number of retirees increases will have long-term implications for the future. From 1994 through 2003, the number of retirees or beneficiaries increased more than 41.0 percent, from 86,214 to 121,582. As shown in Table 3, the WRS actuary projected, in an analysis completed in 2002, that the number of retirees will more than double and reach 275,854 retirees at the end of 2031. It is projected to subsequently decrease and eventually reach a level at which it will remain relatively constant. The actuary has also projected that the ratio of active members to retirees will decrease from 2.33 in 2001 to 0.95 in 2031, then start to increase again as the number of retirees begins to decrease.

Table 3

Actuarial Projection of Present and Future Retirees[1]

December 31	Present Retirees	Future Retirees	Total Retirees	Ratio of Active Members to Retirees
2001	112,177	0	112,177	2.33
2011	76,399	105,592	181,991	1.43
2021	42,689	210,073	252,762	1.03
2031	15,107	260,747	275,854	0.95
2041	2,473	261,724	264,197	0.99
2051	265	237,081	237,346	1.10

[1] Based on an analysis the WRS actuary completed in 2002 for the State of Wisconsin Investment Board. In the analysis, the actuary assumed that the number of active members will remain constant at the December 31, 2001 level.

As the number of retirees has increased over the years, the amount paid in retirement benefits has also increased. For example, benefits increased approximately 170.0 percent, from $1.0 billion in 1994 to $2.7 billion in 2003. Further, benefits and expenses began to exceed contributions in 1992, requiring the use of interest and dividends to help meet benefit obligations. According to the actuary, the liquidity needs of the WRS are as expected, based on its stage of maturity, and are similar to those of several other public pension plans. However, the changing liquidity demands will need to be considered in future investment decisions in the long-term. The State of Wisconsin Investment Board periodically meets with the actuary to consider the potential effect the liquidity needs may have on investment decisions for the WRS.

Accumulated Sick Leave Conversion Credit Program

Another major program administered by the Department is the Accumulated Sick Leave Conversion Credit program, which had assets totaling $1.6 billion at the end of 2003. Most State employees accrue sick leave at the rate of five hours every two weeks, to a maximum of 16.25 days a year. Unused sick leave hours accumulate from year to year. At the time of retirement or layoff, state employees may convert the value of their unused sick leave accumulation balances into accounts to be used to pay premiums for coverage in the State's health insurance program. Surviving insured spouses and dependents are also eligible to use sick leave credits to pay health insurance premiums upon the death of the employee or retiree. In 1995, the Legislature authorized the establishment of a supplemental program to provide matching sick leave credits for participants with 15 or more years of state service.

The Accumulated Sick Leave Conversion Credit Program has been affected by recent legislation enacted to address the State's budget difficulties. In 2001 Wisconsin Act 109, the Legislature suspended payment of contributions to the program during FY 2002-03. Contributions that state agencies otherwise would have paid to the Department, which are estimated to be at least $60 million, were instead lapsed into the State's General Fund. The 2001 legislation negatively affected the program's financial position. However, the financial position improved significantly with the issuance in 2003 of appropriation bonds to finance payment of the unfunded actuarial liability. Issuance of these bonds was authorized in the 2003-05 budget legislation.

Approximately $782 million in proceeds from the $1.8 billion issuance of appropriation bonds was transferred to the Accumulated Sick Leave Conversion Credit program. These funds cover all but $54.7 million of the unfunded liability reported in the program's financial statements at the end of 2003. The remaining unfunded liability in the program includes amounts owed by state authorities participating in the program, of which the University of Wisconsin Hospital and Clinics Authority and the Wisconsin Housing and Economic Development Authority are the largest.

In contrast to the WRS, the Accumulated Sick Leave Conversion Credit program had not assessed interest on outstanding balances. Consequently, the State's objectives in bonding for the accumulated sick leave conversion credit liability were to address current State budget needs and to earn higher returns on bond proceeds credited to the program than the interest paid on the bonding, with the ultimate goal of reduced contribution rates in the future. If the program's assets, which are invested with the Fixed Fund, earn the actuarial assumed return of 7.8 percent, the State will be successful in its goal. However, if the Fixed Fund returns less than bonding interest costs over the period the bonds are repaid, the State will not be successful in achieving expected savings.

Benefit Payment System Project

Beginning in the late 1990s, the Department initiated steps to develop a new benefit payment system. However, it experienced several major problems with the system's development and, in early 2004, terminated contracts with vendors responsible for system development and project monitoring. After evaluating the project's problems, the Department recently contracted with another firm to begin a restructured project to address its aging benefit payment system.

History of the Project

In 1992, the Department implemented the Wisconsin Employee Benefit System (WEBS), which is an automated system that maintains and processes employer and participant account information. As part of this effort, the Department retained its existing payment systems, which were developed in 1977, to process annuity, disability, and special payments. In the late 1990s, the Department initiated steps to implement a new benefit payment system to replace the annuity system, which uses outdated technology and is difficult to maintain. The new system was also intended to replace the payment functions of the WRS lump-sum payment system and the accumulated sick leave conversion credit system. The new benefit payment system was expected to integrate annuity payment activities with WEBS and other department data systems; improve data maintenance and updating capabilities; and enhance on-line access to annuity and other payment data.

The Department received initial authorization of $430,400 in segregated funding for a new benefit payment system as part of the State's 1999-2001 biennial budget, but initial efforts were delayed because of the need to prepare the Department's computer systems for the year 2000. In 2000, after work on planning for the new system had begun, the Department concluded that developing the new system would require more effort and resources than originally expected. In mid 2000, it hired Complete Business Solutions, Inc. (now Covansys Corporation), which had system development experience with other public retirement systems, to assist it in analyzing system development options and business process flows at contract amounts totaling $247,875. As part of this process, the scope of the system project was expanded to provide for additional automation and integration of the Department's processes. In the 2001-03 biennium, additional spending authority of approximately $5.5 million in segregated funding was made available for the project.

Following a competitive procurement process, the Department engaged Covansys as its external vendor for system development in February 2002, at a contract amount of $4,474,625. At that time, the Department also contracted with MAXIMUS, Inc. at a contract amount of $744,400, to serve as the project monitor because it did not have the technical expertise to effectively manage the vendor.

In response to ongoing difficulties and delays, contracts with Covansys and MAXIMUS for the development of the new benefit payment system were terminated in January 2004. The Department determined that it had spent approximately $3.9 million for one-time development and implementation costs for the system project, as shown in Table 4. However, the Department indicates that it has been able to use a portion of the completed work as a starting point for the revised project, which it estimates has saved between six and twelve months of time.

Although the Department had not made a payment to Covansys since February 2003, a settlement agreement reached by the Department and Covansys in December 2004 provided for an additional $350,000 payment to Covansys, including $170,000 that the Department had originally withheld and $180,000 as a partial payment for approved work. Covansys had initially requested payment of $901,000 during negotiation of the settlement agreement.

Table 4

Benefit Payment System Project Budget and Costs[1]

Category	Budget[2]	Costs
Covansys[3]	$4,474,625	$1,884,074
MAXIMUS	744,400	402,237
Contract Programmers	655,813	570,300
DET Development Charges[4]	315,000	221,326
Contingency	720,300	0
Training, Equipment, and Tools[5]	496,000	818,304
	$7,406,138	$3,896,241

[1] The amounts presented represent the one-time costs associated with the development and implementation of the system project. These amounts do not include other costs related to the project, such as software maintenance and staff time, that could not be clearly distinguished from non-project costs.

[2] The budget reflects the amount the Department budgeted for the project and includes $5.5 million released from the Joint Committee on Finance, as specified in 2001 Wisconsin Act 16, s. 9116 (1mk), and additional funds allocated to this project from the Department's base budget.

[3] The costs for Covansys include $350,000 the Department agreed to pay Covansys as part of a settlement agreement in December 2004, but do not include exploratory and planning costs incurred prior to the 2002 system development contract with Covansys.

[4] DET Development Charges are charges from the Department of Administration's Division of Enterprise Technology (DET), which is responsible for maintaining the State's mainframe operating system.

[5] The Department has indicated that the costs exceeded the budget because it purchased tools and equipment that were not originally anticipated and sent more staff to training than originally estimated.

Assessment of the Project

In early 2004, the Department went through a competitive procurement process to hire another external consultant, Virchow Krause & Company, at a contract amount of $198,000, to assess problems with the past project and to develop an approach for recovering it. In its July 2004 report, Virchow Krause identified several factors contributing to the project's difficulties. Among the major problem areas noted were:

- management of the project—the Department did not assign a person with sufficient project management experience and time to oversee the project;

- size of the project—the scope of the project grew significantly from its original inception, and the Department did not have project management skills commensurate with the scope, challenge, and risks of the project;

- technical knowledge—the project team lacked knowledge of key system development methodologies, which contributed to an over-engineered technical architecture;

- management of the contracted vendors—the Department placed too much trust in its vendors and did not have adequate procedures in place to monitor and hold them accountable; and

- project monitoring role—the Department recognized some of its limitations in project management experience and skills prior to the start of the project and hired a project monitoring vendor with experience in public retirement systems and information technology. However, the project monitoring vendor failed to perform its intended role, and the Department did not detect or act upon the vendor's failure in a timely manner.

During the course of our financial audit, we also heard concerns about the adequacy of the vendor selection process. Some Department staff expressed concern that the top-scored vendor in the initial evaluation process did not receive the contract. This matter was of particular concern to staff who had reservations about the qualifications of the vendor selected, including lack of experience in implementing a large-scale project using similar technologies. Conclusions regarding the qualifications and capabilities of the top two vendors appeared to differ between the Department's information technology staff and operational staff involved in the evaluation and selection process.

Covansys was selected after additional analysis of the two top-scored vendors was completed, including vendor presentations, reference checks, and best and final offers. Selection of Covansys was a management decision based in part on a belief that its experience in developing system options for the benefit payment system enabled it to provide the most accurate bid, and in part on concerns that the other vendor's cost proposal was not a credible best and final offer that represented a fixed price, and unexpected cost increases could occur in the future. The Department also noted that Covansys' experience with other public retirement systems was a factor. Whether the project would have been successful if the other vendor had been selected cannot be determined, especially considering the other problems noted in the project by Virchow Krause. However, the problems encountered in the project clearly suggest that a different approach is needed in the future.

Future Plans

In its report, Virchow Krause recommended an approach for proceeding with the benefit payment system project and offered several best practices for project management that could be applied in the future. A major aspect of the recommended approach was to restructure the scope of the project in separate phases, with the first phase being replacement of the annuity system. Subsequent phases would be to replace, interface, or integrate with other systems and processes.

Following release of the consultant's report, the Department went through a competitive procurement process for phase 1 of the revised system project and contracted with another external firm, nVISIA, in February 2005, at a contract amount of $4,480,000. Phase 1 is expected to be implemented in 2006, with the first annuity payment from the new system scheduled for February 1, 2006. The Department also has reconfigured its staffing for the project to provide a more focused sponsorship and management structure for the project.

Funding for continued development of the new benefit payment system will likely become an issue as the Department proceeds with the system's various phases. The Department, which still has authorized funds available, did not request any additional funds for the project in the 2005-07 biennium. However, the Department anticipates that it will need to request additional funding in future biennia for additional functionality, some of which will be incorporated into the new payment system.

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