

REPORT TO
UTAH STATE LEGISLATURE
REPORT NUMBER 89-11



A PERFORMANCE AUDIT
OF THE
UTAH RETIREMENT SYSTEM

October 1989

Office of
LEGISLATIVE AUDITOR GENERAL
State of Utah



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October 16, 1989

TO: THE UTAH STATE LEGISLATURE:

Transmitted herewith is our report, **A Performance Audit of the Utah Retirement System** (Report 89-11). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

Wayne L. Welsh
Auditor General

WLW:syg

DIGEST OF A PERFORMANCE AUDIT OF THE UTAH RETIREMENT SYSTEM

The primary purpose of the audit of the Utah Retirement System (URS) was to complete a detailed follow-up of a our previous audit reported in December 1982. Currently, seven board members oversee the URS which acts as an independent agency. The board's responsibilities include policy development for fiduciarly sound investment strategies and proper administration of public trust funds. URS provides retirement, disability, death, and other benefits to eligible members and beneficiaries. The audit reviewed four operational areas (personnel, payroll, building utilization, and travel) and assessed the performance of URS investments with a follow-up on real estate investments.

The four operational areas showed a general lack of controls by the URS resulting in expenses being incurred which could have been avoided. Many of the concerns discussed in these areas could have been avoided had the URS developed appropriate controls when they left the state system. Trust funds have been used to cover unnecessary administrative expenses. The use of these funds for administrative expenses demonstrates a lack of proper oversight on the part of URS management. However, management is taking action to implement most of the operational controls recommended in this report.

The review of the investment performance shows URS ranks in the lowest quartile compared to other investment funds performance. The main causes for low returns are below median returns for equities (both real estate and stocks) and asset allocation. However, URS investment performance has shown some improvement over the last 5 years. The main issues of this report are summarized below.

Compensation Plan Is Excessive. Currently, URS compensation rates are well above market. Specifically, salary midpoints for nonmanagement benchmark positions averaged 27 percent above market and 23 percent above state employees. Benefits also exceed the market. In addition, seven top administrators have been allowed unnecessary retirement credits at a cost of \$243,260. The Legislature needs to review the law which allowed URS to make these payments. Finally, management compensation has not been appropriately studied. In our opinion, URS compensation should be brought back to market. In fiscal year 1990, a 10 percent reduction in URS employee compensation would amount to a savings of approximately \$400,000 annually. Substantial savings to the trust would occur if URS compensation was brought back to market.

Payroll System Lacks Proper Controls. The URS payroll system lacks the necessary controls to assure appropriate compensation is paid to employees. As a result, trust funds have been inefficiently spent through unearned compensation. In addition, records are inaccurate or incomplete and management has engaged in questionable activities including work for another organization and work completed on personal property. Justified concerns have been raised over nepotism and the hiring of unnecessary staff. The extent of these concerns cannot be adequately documented because records are missing, altered, or incomplete. However, existing records do show personnel costs can be lowered. In our opinion, URS has a responsibility to properly control costs and assure that payroll controls exist.

Human Resource System Lacks Proper Controls. URS human resource management lacks the basic elements of a coherent system in which controls are in place to assure equitable hiring and compensation policies. Discrimination may have occurred because URS lacks competitive hiring practices and has filled jobs with underqualified applicants. Compensation has not been consistently controlled with management making decisions which have prevented the development of a coherent system based on sound principles. These decisions create additional administrative expenses which could be avoided and, furthermore, they expose the trust fund to potentially serious legal liability because of the inequities created.

Investment Portfolio Performance Should Improve. URS has lower returns and risk than those of most other funds. URS investment performance from January 1, 1984 to December 31, 1988 was ranked in the lowest 25th percentile compared to several thousand investment plans, and in the bottom 5th percentile compared to several state retirement plans. Lower risk exposure would result in lower performance during an up or bull market. URS fixed income/bonds and Standard and Poors 500 Stock Index funds helped the fund's overall performance, while URS performance was hurt by a lower-than-average amount of equity/stock holdings, low equity returns, and low returns in real estate investments. A one percent change in investment performance over the past five years would result in approximately \$125 million change in the URS portfolio. However, URS investment performance improved over the last five years. Improvements are mainly a result of the board's decision to increase fund allocation to equity.

Real Estate Investment Returns Are Low. URS real estate investment returns are low compared to average returns reported from three real estate indices we used to compare with the fund's performance. Our audit estimates that URS could have gained an additional \$32 million over the past two years had its real estate portfolio performed at the average

of the other indices. These gains would have been in both income and appreciation of property values with most of the increase in the appreciation of values. Low returns on raw lands and on income properties managed externally have lead to the portfolio's poor performance. In 1982, our audit reported several inappropriate real estate investments which continue to have low performance and are responsible for some 40 percent of the losses over the last two years. In 1983, URS hired an external real estate manager whose purchases have also generally performed poorly.

Building Space Utilization Lacks Proper Controls. Although the state and many private institutions have building space standards for employees, URS does not use any space standards or controls. As a result, space allocations significantly exceed space standards established for state agencies with some URS clerical staff having larger offices than state professional employees. Improved space utilization may have postponed the current construction of a new office building which includes unnecessary amenities. Our review showed both that URS space utilization is low compared to other state office buildings and that URS private office sizes exceed state standards. At a minimum space utilization standards and controls should be developed prior to occupying the new building.

Travel Expenses Lack Proper Controls. The lack of proper controls in URS travel policy and procedures has resulted in comparatively high out-of-state expenditures and double reimbursements. Although URS compensation is higher than market, employees are allowed additional income through travel reimbursements. Travel policies of most other public pension plans provide adequate assurance that travel expenditures are reasonable and that reimbursements are for expenses incurred. However, URS out-of-state travel policy does not assure adequate control over travel expenditures and the amount of travel incurred. As a result, URS out-of-state travel expenditures averaged \$31,400 higher than those of other retirement systems surveyed. Additionally, proper controls do not exist to assure appropriate documentation for reimbursed business meals which appear high.

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Chapter I

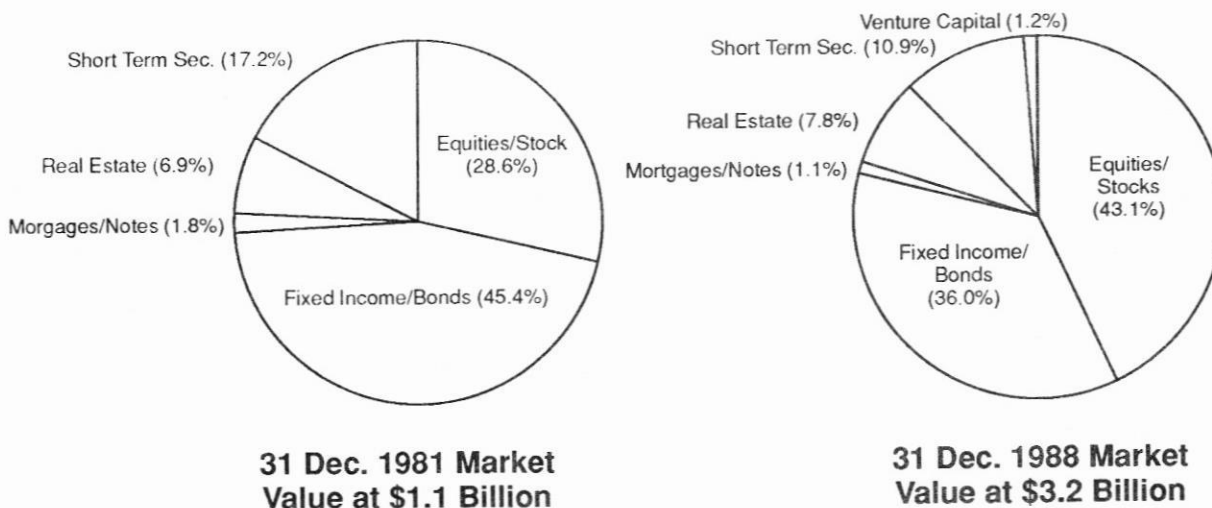
INTRODUCTION

The Utah Retirement System (URS) was created to administer a financially sound method of providing retirement, disability, death, and other benefits to eligible employees and their beneficiaries. URS is overseen by a seven-member board and acts as an independent agency. The statutes grant broad discretion and power to the URS board to manage retirement funds. Utah Code, 49-2 clearly outlines the board's duties and responsibilities, which include acting as an investment trustee and developing policies to operate the system.

The URS board is responsible for policy development to ensure a fiduciarily sound investment program. As an investment trustee, the board oversees the investment and management of nearly \$3.2 billion in assets. The asset value of the fund has increased dramatically over the past seven years due to favorable economic conditions in the nation. The board reviews and establishes asset allocation of all funds to ensure the greatest return commensurate with sound financing and adequate safeguarding of assets. The following portfolio summary identifies the retirement system's increasing asset allocation to equity/stock investments and away from fixed income/bonds.

FIGURE I

Investment Portfolio Changes from December 31, 1981 to December 31, 1988



The most important determinant of portfolio risk and long-term returns is the allocation of assets among asset classes. Asset allocation is estimated to be responsible for 85 to 90 percent of the returns a fund will receive. Greater equity exposure generally raises the risk level and has historically resulted in higher returns. Thus, appropriate diversification is recognized as an important strategy in pension fund investing. As a result, the Utah Retirement System has established ranges which they wish to maintain in each investment category. Figure II shows the ranges recommended by an independent consultant and adopted by the URS board.

FIGURE II
Asset Allocation Objective

Investment Type	Percentage	Variations
Equity/Stocks	55%	+ or - 5%
Fixed Income/Bonds	35%	+ or - 5%
Real Estate	10%	+ or - 3%

In addition to the investment portfolio, the URS board is responsible for policy to ensure a financially sound administrative operation. Although administrative expenses are only approximately \$10 million dollars of the total \$3.2 billion of assets, these expenses directly impact revenue available to pay benefits. For example, a \$20,000 annual savings in administrative expenses over a thirty-year period at the actuarial assumed rate of 7.5 percent will amount in over \$2 million of funding available to pay employee benefits. Thus, the board should encourage the Utah Retirement System to act frugally and conservatively in incurring administrative expenses.

Audit Scope and Objectives

The Utah Retirement System audit was conducted as part of a detailed follow-up of major past audits. In addition, we included in our scope an evaluation of the investment returns obtained by the fund, particularly in the equity portfolio. We also reviewed, at legislative request, URS travel expenditures. Our review was limited to the retirement system and did not include Public Employees' Health Plan or the Deferred Salary Program, although both are located within the retirement agency.

We examined the performance of the investment fund with an emphasis on URS's equity investments. The percentage of funds allocated to the equity investments has been increasing and currently represents approximately 50 percent of the total investment portfolio. The significant emphasis on equities should in the long term increase the overall returns and risk of the pension fund, since equities have historically outperformed other investment instruments.

We completed a detailed follow-up on URS's real estate investments, since such investments had low performance seven years ago. Our 1982 audit found inadequate real estate policies and procedures resulting in poor real estate purchases. The present audit confirmed the 1982 findings but also identified some improvements made in this area by the retirement office. However, URS real estate investments still perform poorly compared to those reported by other funds.

We also completed an audit of four operational areas: payroll, personnel, building utilization, and travel. An examination of these four areas revealed that some administrative expenses could be avoided, with the resulting savings providing additional funds to the trust. In our opinion, the use of trust funds to pay unnecessary administrative expenses demonstrates that the administrative budget is too high. Specifically, the audit addressed the following objectives:

1. Evaluate the URS employee compensation package.
2. Determine if the URS payroll system incorporates proper controls.
3. Determine if the URS human resource system includes appropriate controls.
4. Evaluate URS' investment portfolio performance.
5. Evaluate URS' real estate portfolio performance.
6. Determine if URS has adequate controls over building space utilization.
7. Determine if URS out-of-state travel expenses are properly controlled.

Two consultants assisted us in completing our audit. The first, Dr. Arben O. Clark is the chairman of management department of the college of business at the University of Utah and assisted us in completing the objectives dealing with URS compensation and human resource management. The second, Dr. Ramon E. Johnson is a professor of finance at the University of Utah and assisted us in completing the evaluation of URS investment performance.

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Chapter II

COMPENSATION PLAN IS EXCESSIVE

Since URS stopped operating under the state compensation plan, compensation for URS employees has been high. Eight years ago, when the URS was still under the state plan, compensation was surveyed and compared to market, a measure often used by organizations attempting to develop an equitable compensation plan. Currently, URS compensation rates are well above market. Specifically, salary midpoints for nonmanagement benchmark positions have been well above market, the basic benefits package also exceeds market, and management has been allowed unnecessary retirement credits. In fiscal year 1990, a 10 percent reduction in URS employee compensation would amount to a savings of approximately \$400,000 annually. Substantial savings to the trust would occur if URS compensation was brought back to market.

Total compensation consists of both salary and benefits. Although total compensation can be difficult to compare to market, the market data still gives an indication of what job positions are paid. Total compensation can also vary with company philosophy. For example, URS may need two pay plans, one for positions which are recruited from the local labor market, and one for the few positions which need to be recruited from the national market. Since URS's investment fund manages billions of dollars, some positions may need to be hired and paid based on national information. However, clerical, accounting, and the majority of other positions should be hired locally.

This chapter focuses on the current compensation level at URS, while Chapter IV focuses on the lack of proper controls in URS's human resource system. The issues discussed in Chapter IV have had a direct impact on the compensation being allowed at URS. The high compensation results in fewer funds available for member benefits but more income to URS employees.

URS Salary Ranges Are Higher than Market and State

URS personnel salaries are higher than those received by market and state employees. A pay plan which is used to establish starting salaries and pay ranges should closely reflect market salaries and may even be adjusted downward to reflect higher-than-market benefits. A good pay plan will help assure that employees are properly compensated for the position and services they perform for an organization. The URS pay plan allows employees to start at higher salaries and maintain higher salaries than the

local market. As a result, employees can easily be overpaid for the value of the job position.

The job description as well as internal and external assessments of compensation are used to establish salary ranges. In addition, salary ranges can be used to reflect various organizations' hiring strategies. For example, one organization may set a lower salary range because it wants inexperienced applicants which it can train, while another organization may use just the opposite strategy by setting a higher starting salary. It is important that salary ranges remain narrow so that positions do not become overpaid because of longevity.

Benchmark Salary Ranges Are High

URS pay ranges for selected benchmark positions (this excludes management positions which may not be tied to the local market) are higher than figures reported from several local salary surveys, market data collected by the state, and state salary ranges. As a result, URS employees typically start at higher salaries and can progress to much higher salaries than those allowed by other local companies and the state. Figure III shows how eight benchmark positions, reviewed by state personnel and our consultant, matched with market data.

FIGURE III
Comparison of URS Midpoints with Market

Job Position	Market Midpoint	URS Midpoint	Percent Difference
Assistant to Director	\$ 9.83	\$17.16	75%
Accounting Tech II	8.36	11.21	35
Executive Secretary	9.44	11.21	19
Legal Secretary	8.80	9.73	11
Receptionist	6.77	7.85	16
Property Manager	16.64	19.78	19
Programmer/Analyst II	16.58	18.42	11
Computer Operator II	9.72	12.92	33
Averages	\$10.77	\$13.54	27%

Figure III shows that URS hourly wages averaged 27 percent above market midpoints. The wide range of 11 to 75 percent higher than market would also suggest that URS should be concerned about the internal equity of their job classification. A good classification system tries to ensure that job positions not only are closely tied to market but that they are internally consistent

with other job positions within the organization.

Several URS positions, excluding management positions, were compared to state positions. Our consultant and state compensation experts assisted in reviewing these matches, which give a good indication of where salary midpoints would be had URS remained under the state personnel system. State Personnel reports that the state pay scale with the higher benefits is close to market except for data processing, which has some positions above market. Figure IV shows the comparison of URS salary midpoints to those of the state.

FIGURE IV
Comparison of URS Midpoints with State

Job Position	State Midpoint	URS Midpoint	Percent Difference
Assistant to Director	\$11.54	\$17.16	49%
Public Relations	16.07	22.80	42
Communications	14.44	17.16	19
Internal Auditor	16.07	21.23	32
Deputy Controller	17.79	21.23	19
Accountant I	11.54	13.87	20
Accounting Tech II	8.38	11.21	34
Accounting Clerk	7.45	8.44	13
Executive Secretary	9.39	11.21	19
Legal Secretary	8.89	9.73	26
Secretary	7.45	8.44	13
General Clerk II	7.45	7.85	5
Receptionist	6.65	7.85	18
Property Manager	16.07	19.78	23
Records Manager	13.02	18.42	41
Records Supervisor	11.54	12.92	12
DP Supervisor	20.43	22.80	12
Programmer/Analyst II	18.52	18.42	(1)
Data Controller II	8.38	9.73	16
Computer Operator II	10.52	12.92	23
PC Specialist	14.44	18.42	28
General Service Spec.	7.45	11.21	50
Averages	\$11.98	\$14.67	23%

Figure IV shows that URS midpoints averaged approximately 23 percent above the state midpoints. If URS had remained under the state personnel system, substantial savings would have resulted. These savings could have been used to fund member benefits instead of compensating URS employees.

An example of the impact of high salary ranges is the URS executive secretary position, of which URS has three employees recently promoted into this position. The employees filling this position have an average of 15 months experience (as of 1 July 1989) and earn an average hourly wage of \$9.44. The market data available from salary surveys suggests a salary range midpoint of \$9.44 for this position compared to a URS midpoint of \$11.21 (see figure III). Thus, with only 15 months of experience, these employees are at the market midpoint although still 19 percent below the URS midpoint for this position. Including URS higher-than-market benefits, the compensation for this position significantly exceeds local market.

URS executive secretaries' salaries significantly exceed those for similar positions in Utah state government. An executive secretary working for the state would start at \$7.64 and after a probationary period would earn \$7.91 (the state recently started allowing the probationary increases). Thus, an executive secretary for the state with 15 months' experience would likely earn \$7.91. The URS executive secretary, on the other hand, averaged over 19 percent higher salary and received more benefits than state employees. These examples would suggest that actual salaries for URS executive secretaries significantly exceed market and state salaries.

Market data collected by the state, local salary surveys, and by Arthur Young accounting firm suggest that URS actual compensation is significantly higher than local market. Utah's Human Resource Department reported during the last legislative session that the state's compensation plan closely reflected market data, with state employees' actual compensation being slightly below market. Since URS has higher salary ranges and has given higher increases with a more generous benefits program, URS employees' compensation is significantly above market data used by the state and the salary surveys we reviewed. In July 1988, Arthur Young reported that URS actual salaries averaged higher than local market for the 15 benchmark positions surveyed and that the salary ranges averaged 20 percent higher than local market. Since July 1988, the URS board has allowed employees an average overall increase of over 8.5 percent and a cost-of-living increase of 2 percent. URS increases, compared to a estimated average below 5 percent in this area, means that the difference in salaries is even greater now than what Arthur Young reported.

URS Benefits Are Higher than Market and State

In addition to URS employees having higher salary ranges, URS personnel receive benefits higher than those received by market and state employees. Two approaches were used to evaluate benefits. One approach showed URS benefits were over market by 8 percent while the second approach showed URS benefits over market by 12 percent. In addition, URS benefits are higher than state employees' benefits. The additional benefits for the retirement section are estimated to cost between \$182,000 to \$280,000 annually, when URS policy to purchase additional retirement credits is excluded which is covered in the next section.

URS has a very generous benefit package. For example, URS holiday allowance is high. URS allows its employees 12 paid holidays plus one day of administrative leave for the Christmas season, resulting in 13 paid holidays. One compensation survey indicated that 99 percent of companies located in the Salt Lake City/Ogden area allow less than 13 paid holidays annually.

URS benefits are also higher than those paid to state employees. According to state personnel's last survey, the state's benefit package runs approximately 6.7 percent higher than market. Excluding URS extra purchases of retirement credits discussed in the next section, the URS benefit package adds at least an additional 1.2 percent to the benefit package offered by the state. Thus, the URS benefit package would run at least 7.9 percent higher than market. These additional benefits are listed below.

1. One extra floating holiday per year.
2. Up to 26 days a year for annual leave. State employees are allowed up to 19.5 days a year of annual leave, depending on years of service.
3. Four extra hours for Christmas shopping. This is in addition to four hours of administrative leave allowed by URS and the state during the Christmas season.
4. Four days of funeral leave for relatives, one day for friends. The state permits three days for relatives, none for friends.
5. Service awards after 5, 10, 15, 20, and 25 years of service. URS spent \$3,085 in fiscal 1989 on 19 employees, or an average of \$162 per qualified employee.
6. Christmas gift for every employee, approximately \$15 each.

The cost of these benefits is based on recorded use. Often leave benefits are not properly recorded as discussed in Chapter III. As a result, the estimated cost of benefits is conservative since accurate records do not exist.

In addition, the URS benefit package was compared to a national survey of various companies' benefit packages completed by the US Chamber of Commerce. URS benefits exceed the US Chamber of Commerce benefit survey by approximately 12 percent, excluding the additional retirement credit purchases discussed in the next section. The US Chamber of Commerce conducts a national survey of benefits and attempts to get employers to report all benefits, from employee meals to legally required benefits. This survey estimates the national cost of benefits at 39 percent of payroll costs and for the West at 38 percent. Applying the survey's methods to the URS in fiscal year 1988, we estimate conservatively that benefits are approximately 51 percent of payroll, or at least 12 percent higher than the national average. The higher benefits at URS included the cost of retirement, leave, holidays, and health costs.

The US Chamber of Commerce also estimates the average benefits by industry group. The industry group most similar to URS is banks, finance, and trust companies. This industry group provides benefits which average approximately 34.5 percent of payroll, or 4.5 percent lower than the national average. If URS benefits are about 51 percent of payroll, they are at least 16.5 percent higher than this industry group.

URS management said that they were unaware that their benefits were higher than the state's. The individual over benefits said that benefits have not been accurately compared to market for years. It appears management does not consider the higher-than-market benefits package when setting salaries. The cause of the high salary ranges and benefits are discussed further in Chapter IV.

Management Received Additional Compensation

In addition to the higher benefit package at URS, the liberal interpretation of Utah Code 49-3-4 has allowed URS management to receive additional compensation. URS has set a precedent which could cost taxpayers millions of dollars. In our opinion, \$243,260 paid to URS management in additional retirement credits is unnecessary. The Legislature should review the intent of this law to determine if similar allowances will be made to other public agencies.

Utah Code 49-3-407 allows the purchase of additional retirement years of service. The law allows employees with previous military, educational, other state, or forfeited public service in the state to have this service purchased as additional retirement benefits. The law was modified in 1986 to allow the employer to make the purchase, but historically 95 percent of all purchases have been made by the employee. The few public agencies which have used this law to purchase additional retirement benefits for employees are shown in Figure V and compared to URS.

FIGURE V
Employer Purchases of Additional Retirement
Benefits Compared to URS

Agency	Number of Employees	Retired	Average Years Purchased	Average Paid By Employer
Social Service	8	7*	1.1	\$ 8,954
Attorney General	4	4	1.5	14,030
Financial Inst.	2	2	2.0	11,661
Public Education	3	3	1.0	5,849
Higher Education	2	2	1.1	6,926
Other Units	3	3	1.0	8,209
Weighted Average	22	21*	1.2	\$ 9,004
URS	7	0	2.6	\$34,751

*One employee was terminated.

URS purchase of retirement credits is high compared to purchases of other public agencies. Figure V shows that public agencies which have purchased retirement credits have spent an average of \$9,004 for 1.2 years, compared to URS which has spent an average of \$34,751 for 2.6 years. In addition, all of the public agency employees have retired or left while no one at URS has retired or left. Several public agencies reported that they paid the cost because the position was being eliminated; rather than transferring the employee, these costs were used to encourage the employee to retire, resulting in an overall savings to the agency. URS use of this law, however, has not been intended as a way to eliminate positions and save funds. Also, over 40 percent of the 22 employees in other public agencies participated in the purchase of additional years of service resulting in additional retirement credits than those shown in Figure V, while none of the URS employees participated. Figure VI shows the salary, additional payments, date, and years of service purchased at URS.

FIGURE VI

**Employer Payments for Past Public Service
Made by Retirement for Management**

Position	Current Salary	Additional Years Purchased	Amount Paid	Month/Year of Payment
Executive Director*	\$76,000	4	\$ 74,829	12/87
Attorney	80,800	4	60,718	12/87
Deputy Director*	66,500	3	33,732	9/88
Controller	63,100	3	36,423	12/87
Salary Def. Director	70,100	0.5	7,663	12/87
Benefits Director	47,700	1	11,145	3/88
Assistant to the Executive Director	34,400	3	18,750	9/88
Total			\$243,260	

* Salary data does not include \$15,000 salary made by the executive director working for the National Association of State Retirement Administrators and car allowances for the director (\$8,700 annually) and deputy (\$7,800 annually).

Figure VI shows that URS has used the law to allow additional compensation to its managers and the assistant to the executive director. Payments amounting to \$243,260 were made into the individuals' retirement accounts and were used to buy additional years of service based on the current 2 percent formula applied in figuring retirement benefits. As a result, these individuals will be able to retire earlier than they would had these payments not been made. In the case of the executive director and the attorney, board members said they approved the compensation in executive session. Such approval, however, was not reflected in the board minutes nor in the personnel files. In addition, the service credits purchased for the executive director and attorney have not been properly verified by URS. It appears from the executive director's resume that he does not have four full years of qualifying experience to be purchased. The director also approved payments to selected qualifying positions. We could not determine that URS formally adopted any policy to allow such payments, although management said policy was developed. Later, although policy was developed to allow these payments, such policy never received board approval.

Based on Utah Code 49-3-407, URS developed a retention incentive policy for key employees in October 1988. Under this policy URS can purchase up to four years of additional retirement benefits for qualifying employees. The board, however, never

formally adopted this policy, nor does it appear from the board minutes that this policy was discussed and its impact on management compensation determined. Board minutes of November 16, 1988, reflect that management informed the board "that no action needs to be taken by the board as this matter falls under the purview of the executive director."

It appears that the main purpose of this policy was to provide additional compensation to management. The policy was not generally distributed to employees even though some URS staff qualified. Over one and a half years after the first purchases were made, our audit showed that some qualifying URS employees were still unaware of this benefit. In addition, employees who do not qualify for this extra benefit may feel discriminated against. Although the policy may be legal, we believe it is unnecessary, sets a very expensive precedent, and appears to be another way to provide high compensation to URS employees.

At least four main reasons exist why this URS policy is unnecessary as a retention incentive program. First, better options exist for retaining employees and have been used by URS. For example, a few years ago URS management expressed concern to the board about losing the data processing manager. The board responded to this concern by increasing the manager's compensation in order to retain his services. Second, not all quality employees would qualify for this program since they would not have the required type of experience. Moreover, employees qualify based on previous work history and not current value to the organization. Third, the purchase of additional retirement benefits results in the employee qualifying for retirement after a shorter work history. The prospect of an earlier retirement means losing a valuable employee sooner than would otherwise have occurred. Thus, the incentive does not necessarily retain the most valued employees but allows them to retire sooner. Fourth, some employees receive double payments for retirement. For example, some employees may elect to take out their retirement from one program when they quit and come to work for the state, thus receiving this benefit. After coming into state employment, the employer, not the employee can purchase the previously cashed out credit. Employees receive a double benefit, once when they elected to take the retirement funds out and once when the agency repurchases the service credits.

The Legislature should examine Utah Code 49-3-407 and determine if its intent was to allow agencies such a broad use in purchasing previous experience for retirement. The URS executive director feels that all employers should provide this benefit to employees. We believe if the URS practice were followed by every member of the retirement system, then tens of millions of taxpayers' dollars could be spent. In our opinion, the law needs to be amended.

Since the URS compensation plan currently appears to exceed market and no adequate study has been completed to determine if compensation is appropriate, the \$243,260 credit to these

individuals' retirement account represents funds which should have remained within the trust. In our opinion, the use of the trust fund to pay this benefit is unnecessary. URS policy in this matter should be discontinued since better options exist for retaining valuable employees.

Management Compensation Needs Proper Study

While URS benchmark salaries are higher than market, its management salaries are even relatively higher, a situation which suggests that URS needs to do an adequate compensation study. Arthur Young's salary survey and state compensation specialists both suggest that relative salary differences between URS management and the local market are larger than for nonmanagement. A case could be made for some management positions being hired on a national basis with national data used to support compensation packages. However, URS has never had an adequate study completed to determine what compensation is on a national basis. The salary ranges and salaries have been determined by management with the board setting the executive director's salary.

It is difficult to determine where top management positions would fall on a salary range. The variety, complexity, and wide salary ranges for management positions make them difficult to match. In addition, URS management feels that Utah's pension plan is significantly different from other public pension plans and salary ranges are not directly comparable.

Although management salaries are difficult to compare, some indicators can be used. For example, a comparison of the URS controller position with the state's director of the Division of Finance shows the salary is high for the local area. The director of the Division of Finance has greater supervisory responsibility with a much larger professional staff, oversees several agencies' accounting functions with URS financial reports included, and has a salary which is above the established range because of his experience. Yet the URS controller's salary is only 2 percent below the director's. Factoring in the URS higher benefit package and the Controller's \$36,400 employer-paid additional retirement credits, we find that the controller's total compensation actually exceeds the director's whose duties are significantly more demanding. In our opinion, this kind of situations creates serious inequities.

We collected salary information from seven western states and six public plans with asset holdings similar to URS to indicate what other plans pay for three management positions. The information was not collected as part of a salary survey but used to give some indication of salaries at other public pension funds. Although we found a wide salary range for management positions, the average was less than URS salaries. We are aware that to fill some top

management positions URS may compete on a national level and that these few positions need to be paid at a level comparable to national salaries.

The wide variation in salaries among public plans requires URS to do a comprehensive study of management salaries. Benefits and other compensation must also be considered when establishing management's compensation. The URS benefit package exceeds market by 8 to 12 percent, and the additional purchase of retirement credits must be considered in setting management's salaries.

In addition to salary and benefits, the URS executive director and deputy receive car allowances amounting to \$8,700 and \$7,800 annually. In our opinion, these allowances are high. In Utah, the highest actual cost of operating a state car is approximately \$590 a month. The cost for the car is high because it is driven over 2,500 miles a month, normally, the average cost for most state vehicles is about \$315 a month. This figure compares with URS board-authorized car allowances of \$725 and \$650 a month for the director and deputy respectively. These car allowances, more than twice the state average, appear especially high since most other public pension plans surveyed do not provide any car allowance to their managers.

The URS board must actively seek appropriate information in evaluating and establishing salary ranges and other compensation. Otherwise, no rationale exists for setting compensation. For example, the board chairman said that the board decided to pay the executive director over \$74,800 in retirement benefits in 1987 because they could not provide the salary he deserves. However, we could not find any objective data that the board could use in coming to its conclusion. As a result, the board had no means of determining what is appropriate compensation for the executive director position.

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Chapter III

PAYROLL SYSTEM LACKS PROPER CONTROLS

The URS payroll system lacks the necessary controls to assure appropriate compensation to employees. As a result, trust funds have been inappropriately spent, records are inaccurate, and management has engaged in questionable activities. Concerns have been raised over nepotism and the hiring of unnecessary staff. The extent of these concerns cannot be adequately documented because records are missing, altered, or incomplete. However, existing records do show personnel costs can be lowered. In our opinion, URS has a responsibility to properly control costs and assure that controls exist over payroll.

Payroll controls are essential to assure accurate compensation to employees. The practice of hiring relatives, as explained in Chapter IV, increases the need for better controls. Having employees who are related increases the chance of circumventing established controls. In addition, management can override existing controls. These controls are established to ensure employee work hours are properly tracked, payments reflect hours worked, and policies are uniformly applied to employees. Payroll reports should be independently verified to assure accuracy. URS payroll controls were inadequate resulting in inaccurate reporting of employees hours, inappropriate payments, and failure to follow policies. In addition, URS does not independently verify payroll reports. URS management recognizes these concerns and has begun taking corrective action.

Poor Controls Resulted in Inappropriate Expenditures

Trust funds have been used to pay inappropriate costs. Specifically, inappropriate wages have been paid and compensatory time has been misused. Contrary to accepted business practices, URS existing records show that employees have been treated differently, policies have not been followed, and pay has not matched the hours worked. These practices would not have occurred had URS developed adequate controls.

Employees were allowed inappropriate additional payments and the data processing division's misused compensatory time. The data processing division was reviewed because data processing reports a backlog in programming and has recently hired additional help. In our opinion, the data processing division has artificially created a backlog of programming requirements by allowing employees to take off more compensatory time than allowed by policy.

Inappropriate Wages Were Paid to Employees

Payments were made to employees which clearly violated policy or were not cost effective. For example, employees have been paid although they were not required to work for the time which was paid. Unfortunately, management has been involved in some of these concerns but has assured us that corrective action will be taken.

The extent of funds being inappropriately spent is impossible to determine. For example, to identify employees who were paid but who did not work requires determining that the employee was involved in some other activity. The audit was able to determine a couple of cases where this occurred, but the extent of these inappropriate payments is impossible to determine accurately. Also, the general lack of control has resulted in inaccurate and incomplete records, which is discussed in the next section. Figure VII lists several examples of employees receiving inappropriate compensation.

FIGURE VII

Examples of Inappropriate Compensation

- 1.* One employee received the following overpayments:
 - A. Salary increase was given before probationary period was completed which violated established policy.
 - B. At least four time sheets showed payment for an extra hour or two beyond the hours actually worked.
 - C. At least 30 hours were paid to the employee who was not at work but on leave.
 - D. Unused sick leave was paid when the employee was terminated.
 - E. 22 hours of compensatory time was paid but not earned.
 - F. At least 40 hours were paid while the employee was out of town on a field trip. No documentation exists to show these hours were worked.
 - G. It appears the employee was paid twice for administrative leave allowed only once.
 - H. The employee was overpaid for holidays and sick and administrative leave because hours were not prorated.
- 2.* One employee was paid at least an extra day of leave and took funeral leave for a friend on a Friday when the funeral was in town on Saturday.
- 3.** One employee was paid for 12 hours worked when on annual leave.
- 4.** One employee was paid 15 hours worked when on leave.
5. Part-time employees receive excessive payments for holidays and sick and administrative leave. Many of these part-time employees are related to URS employees.
6. Five employees used personal leave when other leave should have been taken. Three employees were related to management. This policy has not been properly followed and has been misused by management.
7. Temporary employees were paid for holidays although the employee did not have to work. This practice does not efficiently use trust funds with most temporaries being friends or relatives of URS employees and should be discontinued.
8. Inappropriate overtime payments were made to employees. Some employees were paid too much for overtime while others, exempt from overtime because of their position and salary, were given overtime pay. Both practices are against URS policy and should be discontinued.

*Designates an employee related to the individual over payroll and personnel.

**Designates an employee related to URS management.

The reasons for inappropriate compensation range from misuse of policy to failure to record an employee's leave slip. These examples were much more common among staff related to management than other employees. This frequency would suggest that nepotism is a concern at URS and is discussed further in Chapter IV. The examples are not discussed in greater detail because management has agreed to take the necessary corrective steps.

Compensatory Time Has Been Misused

Compensatory time policies need to be followed. Data processing allows employees excessive compensatory time, resulting in an artificial backlog in programming requests. Data processing has allowed compensatory time at time-and-a-half for overtime hours for employees which do not qualify under federal labor standards for time-and-a-half pay. This practice is against URS policy which does allow straight compensatory time for overtime, does not efficiently use staff time, and creates inequities among employees. Obviously, when data processing employees receive excessive compensatory time, programming time is lost. An artificial backlog of programming results and leads to an unnecessary need for additional help. In our opinion, this expenditure is inappropriate.

The impact of excessive compensatory time on programming requirements could not be determined since data processing did not have complete compensatory time records. For example, recent legislation for the early retirement and noncontributory programs increased the need for programming. Several retirement divisions including data processing had granted overtime to their staff to handle these new programs. These programs could have significantly contributed to the current backlog but accurate records do not exist to determine to what extent.

Policies on both wages and compensatory time need to be followed. The individual responsible for payroll did not properly follow or enforce such policies. According to this individual, division directors were given the authority to allow some of the wage abuses and management in general supported or allowed the abuses to occur. However, the individual over payroll also was not appropriately following policy.

Records Are Not Accurate or Complete

The extent to which trust funds have been inappropriately spent cannot be determined because payroll records are not accurate or complete. Controls in a payroll system should assure that accurate and complete records are kept. Federal law and good

management practice require that records be used to properly document employee compensation. URS, however, lacks basic controls to assure accurate and complete records. For example, full-time employees do not keep time sheets but are supposed to report exceptions to the forty-hour work week.

URS records are not properly controlled to assure accuracy and completeness. Specific legal requirements state how long and what records must be maintained. Our audit showed that many of these records were not kept as required. Part-time employee time sheets were missing from payroll records, some division supervisors did not keep compensatory time records, and 1988-89 records used to track employee leave were missing or incomplete with leave records before 1988 not available. During the audit two URS employees stated that pre-1988 leave records existed and were located in the administrative service director's cabinet. A search of the cabinet yielded no records. In addition, existing records appear to have been altered or are incomplete.

Records Have Been Altered

Several URS payroll records were changed without explanation. Since proper controls do not exist, it cannot be determined if these changes were appropriate. Since only part-time employees have to submit time sheets, our review was limited to only a sample of these employees. All parties involved with the record changes either did not remember or denied altering time sheets. Figure VIII shows some of the changes discovered in this small and limited sample.

FIGURE VIII
Changes to Payroll Records

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1. Time sheet showing 5 hours worked per day for two weeks was changed to show 8 hours worked per day. Thus, the employee was paid for 80 hours instead of 50 hours.
 2. "Personal Leave" was whited out on an employee's time sheet.
 3. Leave was changed to hours worked on at least six time sheets.
 4. Annual leave was changed to sick leave on various time sheets or leave slips.
 5. An employee's leave slip was changed from what the employee submitted.
 6. A time sheet showing 20 hours worked was changed to 40 hours.
 7. A time sheet was changed adding annual and sick leave to increase the pay to an employee.
-

Since URS lacks proper controls, these record changes cause concern. For example, payroll records which were being audited were removed from the files and placed in a location known only to the administrative service director. Nearly a week later, the director returned to work and admitted to moving the payroll records even though subject to review. When time sheets were finally reviewed some were missing and others had been changed. The general lack of control made it impossible to determine when and why these records had been altered.

Employee comments concerning payroll records could not be relied upon. Some URS employees kept changing their original comments when presented with records refuting their statements. Other employees stated that concerns not covered in this report existed but felt uncomfortable telling audit staff about these areas.

Leave Records Are Inaccurate

Not only have records been altered but leave records have been found to be inaccurate or incomplete. Submission of a leave request is vital in the URS system because no full-time employee turns in a time sheet. Consequently, the leave slip is the only document reporting activity for a pay period. If a leave slip is not turned in it is assumed the employee worked a full pay period. Three main concerns are briefly addressed in this section. First, some

employees would not submit leave slips when they were on leave. Second, leave slips submitted to payroll were missing and not recorded. Third, leave slips were not properly recorded. Although these inaccuracies existed among various employees, they did appear to be more common among employees' who were relatives of management.

Leave slips were not always submitted and properly deducted from employee payroll records. For example, a member of top management took sick leave during the first few months of 1989. However, no sick leave slips were submitted. A sample of ten other employees found at least three employees who appear not to have submitted all their leave slips. Since the employees did not report the leave, the leave was not deducted from their record. Obviously, failure to report leave results in unearned additional leave benefits to employees.

We found that leave slips submitted to payroll were missing. We took a limited sample of employee copies of leave slips. We found some instances where employees had copies of leave slips submitted to payroll but because payroll did not have any copies, the leave taken by the employees was not properly deducted.

Payroll did not properly record leave slips. We found instances where leave slips were submitted but not deducted from the employee's leave record. Failure to record leave results in the employee's leave balances being overstated. In addition, some leave slips clearly requested annual leave but sick leave was deducted instead.

Historically, URS payroll controls have not resulted in properly maintained or accurate records. Management has agreed to improve the controls to assure that documents are properly maintained and are accurate.

Proper Controls Would Have Prevented Management From Engaging in Questionable Activities

A third area in which controls are needed is management use of staff and office time. Management should assure activities which it is engaged in do not misuse staff or their time. URS management has participated in questionable activities during working hours taking unfair advantage of its position. These activities include working for the National Association of State Retirement Administrators (NASRA) and using staff to repair management's personal property. Employees have expressed concerns about these practices and management has agreed to discontinue the practices discussed in this section.

The URS executive director acts as the administrative officer for NASRA and is paid by NASRA for these duties. The director has involved several URS administrative staff in NASRA-related duties. Apparently, some of this service is on a voluntary basis while some is paid for by NASRA. The problem is distinguishing between what is paid for and what is voluntary time, since NASRA-paid services should definitely not be performed during office time.

During the audit, allegations surfaced that URS employees had worked on management's personal property during office time. Although some employees denied that they worked during office time on management's property, they did report that they were asked by management to perform some work and they completed work on office premises. In our opinion, management misused its position by allowing employees to work on its personal property.

NASRA Duties Not Properly Controlled

As administrative officer for NASRA, the URS executive director receives an annual salary of \$15,000 from NASRA. His duties include keeping the accounting records, arranging and selecting sites for the annual NASRA conferences, and collecting dues. URS board members were aware of the director's involvement with NASRA, but they did not know that he was on salary and that some of his administrative staff were compensated by NASRA for services performed.

The director's assistant and one executive secretary were each paid for secretarial services they performed for NASRA in 1987 and 1988. The former was paid \$850 and the latter \$700 for NASRA-related service. Since URS does not properly account for full-time employees' time, we could not conclusively determine if NASRA duties were completed during regular working hours. But evidence exists which suggests that at least some of the work was performed on office time. For example, a review of NASRA records indicates that the director has made site visits in preparation for the annual NASRA conference on office time, a practice we believe is inappropriate.

In addition to employing the director's assistant and an executive secretary (who reportedly only spend a small percentage of their work day on NASRA duties), NASRA has contracted with the communications officer at URS to publish a national survey of state retirement systems. In 1989, this employee received more than \$11,900 from NASRA for material and work for the project. The employee said that 95 percent of the project was completed on his time at home, but during the audit we observed URS employees working on the study.

URS has also reimbursed employees for expenses which were already paid for by NASRA. The executive director had his air fare for a NASRA conference paid twice, once by NASRA and once by URS. The director has since reimbursed URS for the airfare. NASRA also provided meals and reimbursements for meals at meetings and the annual conference. URS employees did not deduct these meals from their travel reimbursement requests and so received payments from URS. The double reimbursement for meals is discussed in greater detail in Chapter VIII.

We believe paid NASRA activities should not be performed on office time. Employees easily get the impression, either rightly or wrongly, that management condones and supports other work during office time. Full-time employees should be required to keep detailed time sheets to account for their time. In addition, management should keep the board completely informed of salaries and payments it and other staff receive from other sources.

Employees Have Worked on Management's Personal Property

Management should be careful in using their position to influence employees' activities concerning personal matters. Apparently, employees have been involved in working on management's personal property. Although these employees said that work was completed during their own time, the activities were completed in a manner which was inappropriate.

An employee alleged that a member of top management had URS staff work on a boat during office time. URS used to have a maintenance shed where work on personal cars and boats was completed. The maintenance supervisor reported that work was completed on the top manager's boat but not on office time. However, the use of a company shed and access to the the manager's boat clearly should have been avoided.

Building maintenance employees worked on another manager's personal home during company time. These employees expressed concern about doing this work but felt they were not in a position to turn the manager down. The employees said they had replaced a water heater, two toilets, and some light fixtures in the home. Although these projects were started during the maintenance staff's lunch hour they took much longer than the lunch hour to complete. The employees reported that their immediate supervisor was aware of the work being completed. In our opinion, the act was inappropriate and represents a misuse of employees time. The employees supervisor should not have allowed them to work on the project under these conditions.

Another employee acted as the general contractor to build a home for a staff employee. Both employees said that they did not do any of their work on office time. One of these employees refused to

answer additional questions, considering it inappropriate for us to look into this matter.

In our opinion, the very appearance of working on personal property has created an environment where employees feel justified doing personal business on office time. Management should not have been involved in having employees work on their personal property. Since full-time employees do not have to account for their working hours, it would be easy for employees to engage in inappropriate activities during company time. URS management and the maintenance supervisor have assured us these types of activities have been discontinued.

Chapter IV

HUMAN RESOURCE SYSTEM LACKS PROPER CONTROLS

URS human resource management has not developed a coherent system in which controls are in place to assure equitable hiring and compensation policies. As a result, discrimination may have occurred with underqualified applicants filling jobs and positions being misclassified. In addition, compensation has not been consistently controlled, and management has made decisions which have prevented the development of a coherent system based on sound principles. These decisions create additional administrative expenses which could be avoided, and, furthermore, they expose the trust fund to potential legal liability because of the inequities created.

Our 1982 performance audit concluded that although the retirement system's personnel office operated legally, some practices were costly. In 1982, the State Supreme Court upheld a judgment by a lower court allowing the retirement system to hire personnel and determine salaries independently of the state human resource system. However, the 1982 audit showed that separating from the state's personnel system cost URS approximately \$141,000 in the first fiscal year. Part of the additional cost was a result of allowing URS employees higher salary increases than what the Legislature authorized for state employees in fiscal year 1982. Additional costs also occurred and continue to occur because URS must maintain and operate a separate personnel department.

The retirement system's current human resource system lacks important components. For example, one important component in any human resource system is a job analysis, a systematic investigation of the necessary skills, knowledge, and abilities someone needs to perform the job adequately. The analysis is the basis for job descriptions, which are essential to determining hiring needs and properly advertising a job opening. The job analysis is used to select employees, establish pay systems, and to see how well one job fits into the organization compared to others. Specifically, one reason why a word processor's job is paid more than a keypunch operator's job is because the processor's job requires more knowledge, skill, and responsibility. Without a good job analysis, it is difficult to identify or defend differences in salary level.

Also, a job analysis allows adjustments between jobs to ensure they fit correctly into the organization. Thus, the job analysis should group the more difficult responsibilities and decisions into the correct positions. For example, an administrative secretary making a management decision might justify a change in position title and compensation when all that is really needed is a job analysis which may recommend the decision be made by someone already in a management position.

This report identifies numerous problems with URS's personnel process, most of which could have been avoided had URS remained under the state's system or they had a qualified personnel manager. This chapter will discuss three concerns that have been identified in the personnel area: employees are not competitively hired, salary increases are not properly controlled, and the URS compensation plan lacks consistent management direction.

Employees Are Not Competitively Hired

Although URS policy requires job positions to be competitively filled, in practice they are not. URS has often not properly advertised a job opening or screened out underqualified applicants. Also, while URS has a policy restricting nepotism, URS has not always followed it. Finally, controls do not exist that assure positions remain properly classified. The results of not hiring competitively have been cases of nepotism, discrimination, filling of positions by underqualified employees, and compensation inequities. It appears to have been common practice for URS to hire relatives or friends on a part-time or temporary basis then promote them to a full-time position. These employees did not have to provide any evidence of meeting the qualifications, and often the full-time job was not advertised outside URS.

Adequate hiring procedures assure that competition exists and qualified applicants are sought. If an agency tends to move temporary or part-time help to full-time positions then adequate competition and qualified applicants must be sought to fill temporary or part-time positions. In addition, if an agency allows job positions to be filled internally, it must assure appropriate competition between qualified applicants within the agency. The majority of URS job positions are not filled competitively.

Job Openings Are Not Properly Advertised

URS does not seem to have followed its own policies on hiring. URS policy is to hire the best qualified applicant at a competitive salary. However, job openings have not always been properly advertised or filled. In addition, URS has an informal policy to try to promote from within. Typically, if there is an opening for a position, a notice is posted internally. The position is filled internally if a applicant within the organization is interested.

We reviewed all the positions hired for the retirement division from January 1, 1986 to December 31, 1988. We found that 31 positions were filled. An examination of the 31 job positions filled revealed a significant number of these positions were never

properly advertised which did not assure competitive hiring practices. Of the 31 jobs, 24 (77 percent) were never advertised outside the organization. Figure IX compares jobs advertised externally with those not advertised.

FIGURE IX

**Job Positions Advertised and Filled at URS
Jan. 1, 1986 to Dec. 31, 1988**

Description	Number	Percent
<u>Full-Time Employees Hired</u>		
Not Advertised Externally	24	77%
Advertised Externally	7	33%
Total Positions Filled	31	100%

Overall, it appears that many full-time positions are not properly advertised, and temporary employees are hired with the intention of moving them into full-time positions. Of the 24 unadvertised positions 9 were filled by individuals who were at one time temporary help (friends and relatives). The temporary help were hired without the position being advertised or proper competition.

In addition, we examined 14 positions filled internally. This examination revealed that 1 position was never advertised internally or externally, 12 positions were hired by the use of internal bulletins only, and 1 position was advertised externally. The 12 positions filled internally were posted at URS for less than four working days with some of the employees hired not meeting the stated minimum qualifications. Also, no audit trail existed to show that several qualified URS employees competed for the job openings. Consequently, it appears inadequate competition existed and management may have already decided on whom to hire before the job was posted.

Better Qualified Applicants Could Be Hired

In addition to not properly advertising job openings, URS has not screened out underqualified applicants. Since the URS compensation package is above market (Chapter II), newly hired employees should typically exceed minimum qualifications for a job

bringing valuable experience into a position. But because URS has not had adequate job descriptions, minimum qualification requirements have not been well defined. Even in a test of minimum qualifications used by URS, many of the employees hired did not meet the minimum qualifications.

Job applicants who filled unadvertised jobs did not have to meet any minimum requirements. In addition, no minimum qualifications were formally established for other job positions. Test results on applicants hired without advertising were often not available since those applicants were not required to take tests typically given for the job position. Thus, we could review only a small number of positions to determine if the employees hired would meet the minimum qualifications.

We did review the personnel files of 17 employees and found 8 which clearly did not meet the minimum qualifications established by URS. For example, some clerical positions required minimum typing skills. However, these positions were filled by employees whose typing test scores were significantly below the minimum typing requirement. Figure X shows the results of applicants reviewed to determine if they met the minimum qualifications for the job.

FIGURE X
Comparison of Employees' Qualifications
to Minimum Qualifications

Description	Hired Internally	Hired Externally	Totals	Percent
Total positions reviewed	9	8	17	100%
Employees meeting minimum qualifications	1	3	4	24
Employees not meeting minimum qualifications	5	3	8	47
Documentation was inadequate to show employees met minimum qualifications	3	2	5	29

Table X shows that 47 percent of the applicants for positions we reviewed did not meet the minimum qualifications advertised. Only 24 percent met or exceeded the minimum qualifications defined by URS. A company can train employees and give them the experience necessary to meet the minimum qualifications, but usually these companies will pay below-market rates to help offset the cost of training these employees. Since URS pays above-market rates, as discussed in Chapter II, and has poorly defined minimum qualifications, candidates for job positions should have consistently exceeded the minimum qualifications.

Nepotism Policy Not Properly Followed

URS hiring practices do not follow system policy, which requires that related employees must be competitively hired through normal hiring practices. As a result, it appears employees were hired based on their relationship with URS employees rather on their qualifications. Some supervisors reported that new employees were hired without even being asked if additional help was needed. These new employees were frequently a relative or friend of an existing employee. In addition, to assure proper controls URS had a policy which required relatives not to work together in the same division.

The URS board received an anonymous letter expressing concern about nepotism in January 1988. According to board minutes, the board decided not to do anything since the letter was not signed. Instead, the board encouraged any employee with concerns to bring the concerns to the board or management. However, since management is perceived to be involved in nepotism problems, employees fearful for their careers, have not brought forth their concerns.

As described in the previous sections, relatives and friends were not competitively hired. A review of the personnel files showed that the vast majority of applicants who filled positions listed a friend or relative as the source of information about the position. Only 4 of the 31 new hires (13 percent) listed an outside agency or advertisement as the source of job opening information. Another 4 (13 percent) did not fill out an application. The remaining 23 (74 percent) listed relative or friend as the source of job opening information. Consequently, most job vacancies were filled by employees' informing friends or relatives of the opening.

Children and relatives of administrative employees are hired with no advertising. Of the 31 new hires, 15 could be identified as a relative or friend of some URS employee. Of these 15 new hires, only 2 were advertised. It appears some of these employees were hired part-time and moved to full-time positions in order to avoid competitive hiring practices. These 15 new hires included 5 children of administrative employees currently working for the retirement office. Four were hired in 1987, and one in 1986. These 5 individuals had worked part-time and/or as temporary employees at

URS and were moved into job positions which are classified as full-time and eligible for benefits. Since most of the individuals were hired on a part-time basis before moving into a full-time job, skill tests or evidence of meeting the minimum qualifications for a full-time job were not required.

URS nepotism policy has not been followed regarding relatives working in the same division. Three daughters of administrative staff have worked as temporary employees within the same division as their parents since 1986. Policy at this time clearly stated that relatives should not be working within the same division. The violation of this policy resulted in additional control concerns. For example, one division director reviewed her daughter's time sheet, a procedure which lacks proper independence. In another division, a daughter's time sheet was never reviewed or approved by anyone.

Positions Are Misclassified

Inequities have resulted not just from hiring practices but also from misclassification of positions. Proper classification of a job helps to determine appropriate salary ranges and identifies individuals qualified to fill the position. URS does not adequately tie compensation to job duties. Employees with similar duties are paid differently, and employees whose jobs have been changed have not had their positions reevaluated.

An important procedure in compensation is periodic job analysis and an internal appeal process. These procedures identify when the basic knowledge, skills, and abilities for a position have changed enough to merit a new salary range. If salary ranges are not tightly controlled, employees are paid beyond acceptable market ranges.

During our review, employees with similar duties, responsibilities, and experience were found to be paid differently. For example, two employees working in the mail room were hired at about the same time and both have similar duties. However, one is paid 24 percent more than the other. In addition, employees with major changes in job duties were identified but no new job analysis was completed to determine appropriate compensation. For example, two employees' job descriptions state they spend over 75 percent of their time managing stocks. However, URS has discontinued the in-house active management of stock funds. Periodic job analysis is essential in establishing proper salary ranges for employees.

Salary Increases Not Properly Controlled

A second area in human resource management needing controls is that of salary increases. In theory, employee compensation should increase based on performance, experience, and opportunities to move up within an organization. However, URS does not have adequate controls over employee compensation. Salary increases are high and are given over a wide range which cannot be tied to job performance or to any logical reason. For example, in fiscal year 1989, URS salary increases averaged over 8.5 percent per employee with a range of 0 to 29 percent. These increases appear to be discriminatory, with performance increases and promotions not properly documented or based on an established criteria.

Although the board authorized a 5 percent performance increase, actual salaries during the fiscal year 1989 increased an average of 8.5 percent. One explanation for the large increases may have been because the personnel budget was too high. The purchase of additional retirement credits in fiscal 1988 showed that URS personnel expenses were high as explained in Chapter II, and no budget reduction was requested the next year. The board chairman explained the increases were allowed because state employees received authorization to increase salaries. However, the Governor allowed only outstanding state employees a 2 to 5 percent increase and unfroze probationary increases. The state personnel office reports that fewer than 13 percent of eligible state employees received a performance increase or salary adjustment, compared to over 95 percent of URS employees.

Performance Increases Were Not Properly Controlled

Because so many performance increases were granted, they do not seem to be properly controlled. Performance increases are usually tied to performance and controlled, with a limited number of people given increases within a narrow range. Yet 95 percent of URS employees received a performance increase. Also, we are concerned about employees which received the same ratings getting vastly different increases with no reasonable justification for the differences. The wide variation of salary increases to employees without justification may be considered discriminatory.

Companies and agencies often use performance increases to reward above-average performance by employees. The URS received board authority to give performance increases during fiscal year 1989. However, a review of URS records shows increases were not given based on performance, as several performance appraisals were filled out after the employee had already received a salary increase.

The number of performance increases should be controlled and individuals rated the same should receive similar increases. However, URS management did not follow any guidelines nor did they have any justification for various increases. For example, the URS human resource office issued guidelines allowing a 5 to 9 percent increase for employees ranked outstanding, compared to the state guidelines of 2 to 5 percent during this period. The actual pay increases of URS employees ranked outstanding ranged from 3 to 15 percent.

A review of performance appraisals provides no evidence to justify the wide variation in salary increases. It appears from a review of several appraisals that excelling at teamwork, cooperation, and getting along with others are the main criteria for judging an outstanding rating. However, we could not find any reason why one individual would receive a 15 percent increase while another would receive only a 3 percent increase.

Because it appears all increases were based mainly on a manager's individual judgment, and not on performance, established guidelines, or market data, employee treatment could be considered discriminatory. For example, 29 employees received salary upgrades or adjustments in addition to a performance increase. A salary adjustment should be based on data which show an employee's compensation is not appropriate for their current duties or experience. However, no qualified individual completed any proper analysis to determine compensation, nor was compensation compared to market. However, all available market data show these positions are already above market.

The director of administrative services said that some division managers preferred to move people up to new salary ranges (grade increases) rather than out on a salary range (step increases), even though the employees duties have not changed. Of the 29 salary adjustments, 14 employees were upgraded into a new salary range, although our audit found no evidence that the previous salary ranges were inadequate or that there had been any change in job responsibilities to justify the increase. Since URS does not properly assess employee duties, there is no basis on which to increase an employee's salary.

Promotions Need Improved Controls

As with performance increases, promotions do not seem to be based on an established system. Promotions should be given when duties significantly change and should be within an established range. For example, the state allows 5 to 10 percent salary increases for promotions. The URS, however, has allowed a wide range of increases in promotions from 9 to 21 percent. Promotions have not but should be tied to market data. Thus, promotions appear to be given based on management opinion and not on a coherent system.

Promotions for fiscal years 1988 and 1989 were not properly controlled. URS personnel records show 9 employees received a promotion in fiscal year 1988. The 9 employees received salary increases ranging from 9 to 21.5 percent, with an average of 14.0 percent. In fiscal year 1989, promotions ranged from 5 to 15 percent, with an average of 9.4 percent for 15 employees. However, all 15 employees also received other increases in 1989. Thus, these 15 employees' average increase was 13.5 percent for fiscal year 1989, with a range of 9 to 20 percent.

The average increases for promotions at URS exceeds what state employees receive, has a wide range, and is not tied to any market data. It appears from fiscal year 1988 and 1989 data that URS does not have an adequate policy for promotions.

Compensation Lacks Consistent Management Direction

A third area of concern in URS's human resource system is lack of consistent management direction regarding compensation. URS compensation policy allows wages which are competitive with the market. Since URS does not have properly qualified staff in-house to determine market compensation, outside consultants have been used. However, management's reliance on and use of outside consultants has been inconsistent.

Since leaving the state system, URS has used three different consultants to evaluate compensation. In 1984, URS hired a consultant from the University of Utah. However, URS disagreed with the results of the study conducted and decided to hire a second consultant. The second consultant made recommendations which generally increased salaries in 1985, 1986, and 1987. Finally, in 1988, URS hired the accounting firm of Arthur Young to survey market compensation.

The second consultant's recommendations to increase specific employees' salaries in 1985, 1986, and 1987 were generally implemented. The board approved the 1985 salary increases which affected nearly half of URS job positions. No board approval was sought for the 1986 and 1987 increases which affected fewer job positions. In addition, URS management made some salary increases, although they were not recommended by the consultant.

Some of the consultants' recommendations were implemented even though URS management did not understand the methodology used. The second consultant used some type of factoring methodology to assess job positions, but no data could be found to show how well-matched these positions were to the market. Although URS was highly critical of the University of Utah's study and later of Arthur Young's study, management implemented the second consultant's recommendations even though they did not understand the methodology used.

Salt Lake County hired a consultant, who was related to the URS consultant, to complete a study based on the same factoring methodology used for URS. However, Salt Lake County human resource staff required the consultant to explain the methodology being used. Although the consulting group explained the methodology, the county could not agree with the approach because it did not appropriately reflect market compensation.

Early in 1988, the retirement office hired Arthur Young to complete a compensation survey. This survey was completed in July of 1988 and showed that compensation at URS was higher than the local market and in some cases well above market. After the release of this report, URS administration requested and received board approval for a 5 percent performance increase in salaries. As discussed earlier, actual salary increases averaged above 5 percent.

The best data the board had available for determining compensation were ignored. Some board members said they were aware of Arthur Young's study but that URS management did not trust the study or the conclusions. The study showed the URS pay plan averaged 20 percent above the local market. To complete the salary survey, Arthur Young also surveyed 15 benchmark positions. This survey showed that actual pay for these positions averaged 11 percent above the pay for similar positions in other companies, even though employees at the other companies had been in their positions 3 years and 7 months longer than URS employees. Thus, URS employees in these benchmark positions were being paid a higher salary with a shorter work history. URS management disagreed with Arthur Young's data, although they never understood how the previous consultant arrived at the increases.

Chapter V

INVESTMENT PORTFOLIO PERFORMANCE SHOULD IMPROVE

URS has lower returns and risk than those of most other funds. Over the past five years, URS ranked in the lowest 25th percentile compared to several thousand investment funds, and in the bottom 5th percentile compared to several state retirement funds. Lower risk exposure would result in lower performance during an up or bull market. URS fixed income and Standard and Poors 500 Stock Index program helped the fund's overall performance, but URS performance was hurt by a lower-than-average amount of equity (stock) holdings, low equity returns, and low returns in real estate investments. (Real estate is discussed in detail in Chapter VI.) A one percent change in investment performance over the past five years would result in approximately \$125 million change in URS portfolio assets. However, URS investment performance has improved over the last five years. Improvements are mainly a result of the board's decision to increase fund allocation to equity.

Utah's risk level was lower than the median of other funds. Investment returns vary with different market conditions but returns have been higher over the long run when higher risk was involved. Lower risk typically results in better performance in down (bear) markets and worse performance in up (bull) markets. Since markets have historically trended upward, over any long period of time investment funds with a higher risk level have typically outperformed others. However, in the case of URS, most investment funds with similar and lower risk still outperformed the URS investment portfolio over the past five and ten years. URS investment officer said that he expects higher returns to be realized by the fund which have not yet been fully reflected in the funds performance and according to one URS consultant, URS risk and returns have shown excellent improvement in the last five years.

Prior to 1982, the URS investment portfolio was constrained by the limitations imposed by state Law. In mid-1982 the Legislature removed legal restrictions placed on the investment program by adding the "prudent man rule". The URS board recognized that higher returns can be achieved with better equity management and through more risk exposure. URS' cash flow position enables it to assume greater risk which provides better long term returns to its members. Since the URS fund has a positive cash flow, the fund can hold investments during down markets rather than selling them at a loss to pay benefits. The board completed an asset allocation study as mentioned in Chapter I which recommended increase exposure to equity. Since that time the board has steadily moved to asset classes offering higher potential returns over the long-term which returns was one reason for the growth in assets held by the fund. Assets also have become better diversified in order to reduce volatility associated with higher potential returns. In addition,

in 1983 and again in 1989, equity managers were either changed or funds allocated to the manager were reduced due to low performance. Both of these actions are supported by the data presented in this report.

Goals are often set by a retirement fund for measuring long-term performance. For example, URS has an overall objective of outperforming inflation by 4 percent. URS's equity money managers were given goals to outperform the Standard and Poor's (S&P) 500 Stock Index. The auditors fully recognize that a 4 percent return over inflation over a long period of time is a difficult goal to achieve especially in times of high inflation or down markets. URS and one URS consultant feels that the URS should be recognized for exceeding their performance goal over the past five years. These objectives were not used to evaluate performance in this report, since the fund goal of 4 percent over inflation was almost impossible not to achieve for a balanced fund over the five years evaluated. On the other hand, none of the specific goals for the equity managers were met by the URS equity managers. For these reasons both the URS balanced fund and equity managers were evaluated against peer group performance indicators rather than established goals although we feel the goals are appropriate. In evaluating overall plan performance and equity performance, we relied on a private consulting group, SEI Corporation, which currently measures investment performance of over 6,000 pension plans and several states.

This chapter has three main sections which help identify portfolio performance. First, a comparison of URS returns to the median of other funds which indicates performance has been low. Secondly, an explanation of why the performance has occurred. Finally, an analysis of risk compared to returns which shows some improvement.

Investment Returns Are Low Compared to Other Plans

Utah's investment performance has been below the median of other funds over the most recent one-, five-, and ten-year period, and for various five-year periods. Although past performance does not necessarily indicate future performance, Utah's past performance has resulted in low returns during a historical up or bull market. The low returns provide less funding for benefits to members.

In 1982, the Legislature removed the legal restrictions placed on board investments by adding the "prudent man rule." This rule requires investment decisions to be made in the interest of the fund participants and beneficiaries with care, skill, prudence, and diligence. The prudent man standard permits a pension plan greater freedom to diversify assets in an attempt to reduce portfolio volatility and increase returns. In response to this change URS has

hired consultants and has systematically moved to increase fund returns.

Performance Is Low Over a One-, Five-, and Ten-Year Periods

The URS fund should be outperforming funds in other states since it operates under no restrictions as to type of investments and it should be moving closer to the performance of private investment funds. However, the URS fund returns have been low compared to those of other states and other investment funds using a one-, five-, and ten-year period of time ending December 31, 1988 which shows the funds performance over various time periods.

Several state retirement funds still place legal restrictions on the type of investing and asset allocation which its plan can make. For example, some states restrict the amount of investments in equity and emphasize fixed income investments. These restrictions may place funds in other states at a disadvantage relative to those funds which operate under the prudent man guidelines since equities have historically outperformed fixed income. Even though some other states' funds are legally restricted, URS performance still appears to be low compared to funds which are evaluated by SEI. Figure XI shows URS' ranking compared to other states' funds as reported by SEI. These rankings are based on a scale of 1 to 100, with 1 being the best performing fund. The ranking of 96, for example, means that 95 percent of the funds in the sample outperformed URS for the five year period evaluated.

FIGURE XI

URS Investment Returns Compared To Returns of Other States' Funds

Period Evaluated	SEI State Funds' Median Return	URS Return	URS Ranking
10-year period	11.7%	11.0%	69
5 -year period	12.6	11.9	96
1 -year period	11.0	9.6	71

Source: SEI Corporation State Funds, period ending Dec. 31, 1988.

URS has been ranked below the median of other state funds. These lower returns result in a significant reduction of funds which could have been available to fund members' retirement benefits.

Since Utah moved to the prudent rule of investing approximately six years ago, it may be better to compare Utah to a broader base group of funds. Figure XII shows how Utah ranked compared to several thousand investment funds evaluated by SEI.

FIGURE XII

**URS Investment Returns Compared
To Returns of Other Pension Funds**

Period Evaluated	SEI Balanced Fund Median Return	URS Return	URS Ranking
10-year period	13.8%	11.0%	100
5 -year period	13.0	11.9	80
1 -year period	11.3	9.6	71

Source: SEI Corporation Balanced Fund, period ending Dec. 31, 1988.

Figure XII shows that URS rate of return on its investments is low compared to the SEI median. Seventy-nine percent of other funds had a higher return over the past five years. Although Utah's rate of return was only 1.1 percent lower than the median (13.0% - 11.9%) over five years, this small difference has a large impact on dollar returns. For example, had URS rate of return averaged at the SEI median every quarter, the fund would have earned an estimated additional \$118 million dollars, according to our calculations.

Performance Has Been Low for Some Time

URS performance has been relatively low over various time periods. A review of URS five-year returns compared with the SEI median shows Utah has ranked in the lower quartile since at least the 1980 to 1984 period. Figure XIII shows URS returns and the SEI ranking compared to other investment funds.

FIGURE XIII

URS Investment Returns Compared To Returns of Other Pension Funds Over Various Five-Year Periods

Period Evaluated	SEI Balanced Funds' Median Return	URS Return	URS Ranking
1980-84	13.3%	11.0%	90
1981-85	15.9	13.7	85
1982-86	18.1	15.8	86
1983-87	13.6	11.9	87
1984-88	13.0	11.9	80

Source: SEI Corporation Balance Fund Executive Summaries.

Figure XIII shows that the five-year period reviewed during this audit was ranked higher than any previous five-year period. This is probably due to the increased allocation to equities over this period. However, returns for the five-year periods demonstrate that the URS fund consistently has performed in the lower quartile when compared to other investment funds.

Low Equity Holdings and Returns Hurt Performance

URS investment performance has been below the median of other funds because of the low amount of equity holdings, low equity returns, and low real estate returns (Real Estate is discussed in Chapter VI.). Low equity holdings would have helped fund performance had URS been in a down or bear market and because equity holdings increased gradually over an up or bull market, consequently, the benefit of the strong market was not fully captured. Fixed income holdings, however, outperformed the SEI median for fixed incomes and provided higher returns, offsetting some of low performance in the equity and real estate area. A comparison of equity managers' results showed that Utah's managers as a whole have not performed as well as managers of other funds.

Investment portfolio performance can be broken down by asset classification. URS fixed income returns were higher than the SEI median, while equity returns were lower during 1984-88 period. Figure XIV shows the comparison of URS with other major indices by major asset classification over the past five years.

FIGURE XIV

**Investment Performance by Asset Classification
Jan. 1, 1984 - Dec. 31, 1988**

Asset Classification	S&P 500 Return	Salomon's Bond Index Return	CPI 5-year Average	SEI Median Return	URS Return	SEI Ranking
Bonds/Income	N/A	12.4%		11.9%	12.2%	42
Stocks/Equity*	15.3%	N/A		14.4	12.9	75
Cash/Equiv.	N/A	N/A		8.4	8.3	56
Total Fund	15.3%	12.4%	3.5%	13.0%	11.9%	80

*Equity money managers can hold cash and cash equivalents as well as bonds, which resulted in lower returns than just stock returns.

Source: SEI Corporation Executive Summary, period ending Dec. 31, 1988.

Figure XIV also shows how the URS investment fund has performed relative to other common indices used for evaluating performance. Figure XIV shows that the URS fund did rank below the median in equity returns, with the SEI median at 14.4 percent and the URS median at 12.9 percent, or a 1.5 percent lower performance.

Three Main Factors Caused Low Equity Performance

Equity holdings adversely impacted URS' investment returns in three basic ways. First, URS equity money managers kept a larger percentage of funds in cash equivalents than did other funds. According to the SEI balanced fund median, equities significantly outperformed cash and cash equivalents, with equities returning 14.4 percent and cash equivalents returning only 8.4 percent. Second, URS had lower average stock holdings compared to other investment plans. Although URS systematically increased allocations to stocks, URS still averaged 40.4 percent in stock compared to 51.4 percent for the SEI balance fund median over the past five years. Since equity or stock holdings provided higher returns than other major asset classes, lower equity holdings resulted in lower overall returns. Finally, stock performance was low compared to stock performance experienced by other investment plans, with URS averaging 12.9 percent while the SEI median for other funds was 14.4 percent.

Equity managers for URS generally hurt themselves with larger than average cash holdings. Equity managers held 16.5 percent in

cash or cash equivalents on average over the past five years compared to the SEI average of 6.7 percent. Cash returns averaged 6 percent lower than equity returns during this time. Large cash holdings add some protection to a fund during a down market but hurt a fund during an up market, since its risk exposure is lower than other investment instruments. Large cash holdings by equity managers over sustained holding periods appears contrary to the specifications that funds were to be invested in equities, and large cash holdings over time result in intolerably low returns for a pension fund.

Equity holdings for URS have averaged lower than other pension funds. Equity has outperformed bonds, cash, and cash equivalents in the long run and in the 1980's. Thus, increasing the allocation to equity will increase a plan's expected rate of return but also will increase the risk exposure of the plan. URS has been increasing the allocation to equity from 31.5 to 43.5 percent over the last five years, with an average of 40.4 percent held in equities. This figure compares with the average of 51.4 percent for other funds used in the SEI balance fund. Since SEI equity returns averaged 14.4 percent compared to bonds at 12.4 percent and cash equivalents at 8.4 percent, the higher equity holdings increased the overall returns to an investment plan and was one reason why most funds outperformed URS.

Equity Managers' Low Performance Linked to URS Performance

Not only have Utah's holdings and returns hurt the fund performance, but Utah's equity managers as a whole have not performed as well as equity managers in other funds. SEI evaluates returns on just equities or stocks after the cash equivalents of equity managers are factored out. Utah's stock returns ranked in the 75th percentile, with an average of 12.9 percent compared to the SEI median of 14.4 percent over the last five years. The low stock performance was the major factor in the low performance by the equity group.

A pension plan can manage stocks in-house, hire equity money managers, or use a combination of both. In addition, it can hire equity managers at various times. URS has used a combination of in-house and equity managers. We reviewed the performance of equity managers that have been with URS over the past five years. Our review excluded some of the more recent hires, such as equity managers for international investments and small capitalized stocks. Our review showed that URS equity managers and in-house equity funds evaluated all performed poorly except the Standard and Poors (S&P) 500 Stock Index Fund. The S&P 500 Index is a computer program model which tries to track the performance of the S&P 500 and generally has helped URS stock performance.

The URS pension plan diversifies its equity holdings by using various styles or strategies in the purchase of stocks. A critical decision is the amount of funds to be allocated to each style. Although most equity managers had goals to outperform the S&P 500, few managers were able to beat the Index over the last five years. It may be of interest to compare the performance of equity managers with similar styles when possible.

Nearly all of Utah's equity managers had allocated larger portions of funds to cash and cash equivalents than other pension plan managers. The overall impact of such allocation was discussed in the previous section and contributed to lower fund performance. Only one equity fund outperformed the SEI median over the five years, and that was the Index Fund. Figure XV shows each fund, the average market value of its assets over five years, the return, and its relative ranking.

FIGURE XV

**URS Equity Managers and Returns
Jan. 1, 1984 to Dec. 31, 1988**

Equity Fund Manager	5-year Average Market Value Of Assets (Millions)	Cash Equiv. (Percent)	Total Returns	SEI Ranking Total Returns	Equity Returns Only	SEI Ranking Equity Returns
External Funds:						
Smoot/Miller	\$306.1	17.4%	12.1%	77	13.8%	59
Value Line	175.5	36.5	13.0	64	16.7	26
Atalanta	122.1	16.1	11.5	81	8.8	98
Public Employee	51.2	23.5	11.4	82	12.9	75
Wasatch	45.5	10.9	7.1	98	7.9	99
In-House Funds:						
Index Fund	350.3	1.2	15.1	32	15.0	44
Internal Stock	127.0	25.3	10.7	88	12.1	83
Stock/Growth	33.0	28.1	3.6	100	4.0	100

Source: SEI Corporation.

Figure XV shows that all equity managers performed below the median except the S&P 500 Stock Index Fund. In addition, SEI has tried to compare various managers' styles. For example, one equity manager may emphasize investments in small companies with high growth potential while another will invest in larger, more stable companies. The style SEI attributes to various money managers can be questioned, but this was the only independent criterion currently available to compare equity managers. Comparing various equity money manager's styles to similar styles and the average returns

experienced by equity funds shows that most of Utah's money managers performed below peer group comparisons. Figure XVI identifies the money managers and shows the returns they experienced for their stock holdings only.

FIGURE XVI
Comparison of Equity Manager Styles to SEI

Equity Manager	SEI Style Classification	Years Reviewed*	Equity Return	SEI Median	URS's Ranking
External Funds:					
Smoot/Miller	Value	4	16.1%	17.4%	77
Value Line	Value	4	21.0	17.4	10
Atalanta	Value	4	10.5	17.4	100
Public Employee	Value	4	16.1	17.4	76
Wasatch	Concentrator	4	9.8	18.1	95
In-House Funds:					
Index Fund	Other	4	17.8	17.1	40
Internal Stock	Concentrator	4	16.5	18.1	64
Stock/Growth	Growth	2	(1.0)	10.2	100

*Data on these funds were available for certain periods of time and usually less than five years. Thus, returns are different than the five-year returns reported earlier.

Source: SEI Corporation.

Value Line equity performance was exceptionally high. However, this equity manager's overall return was diminished because of large cash holdings. Value Line held on average about 36.5 percent of its funds in cash, which had a significantly lower return than stocks. Thus, the poor performance and high cash holdings by equity managers both in-house and those hired externally resulted in overall low performance in the equity group.

Return/Risk Ratio Appears to be Improving

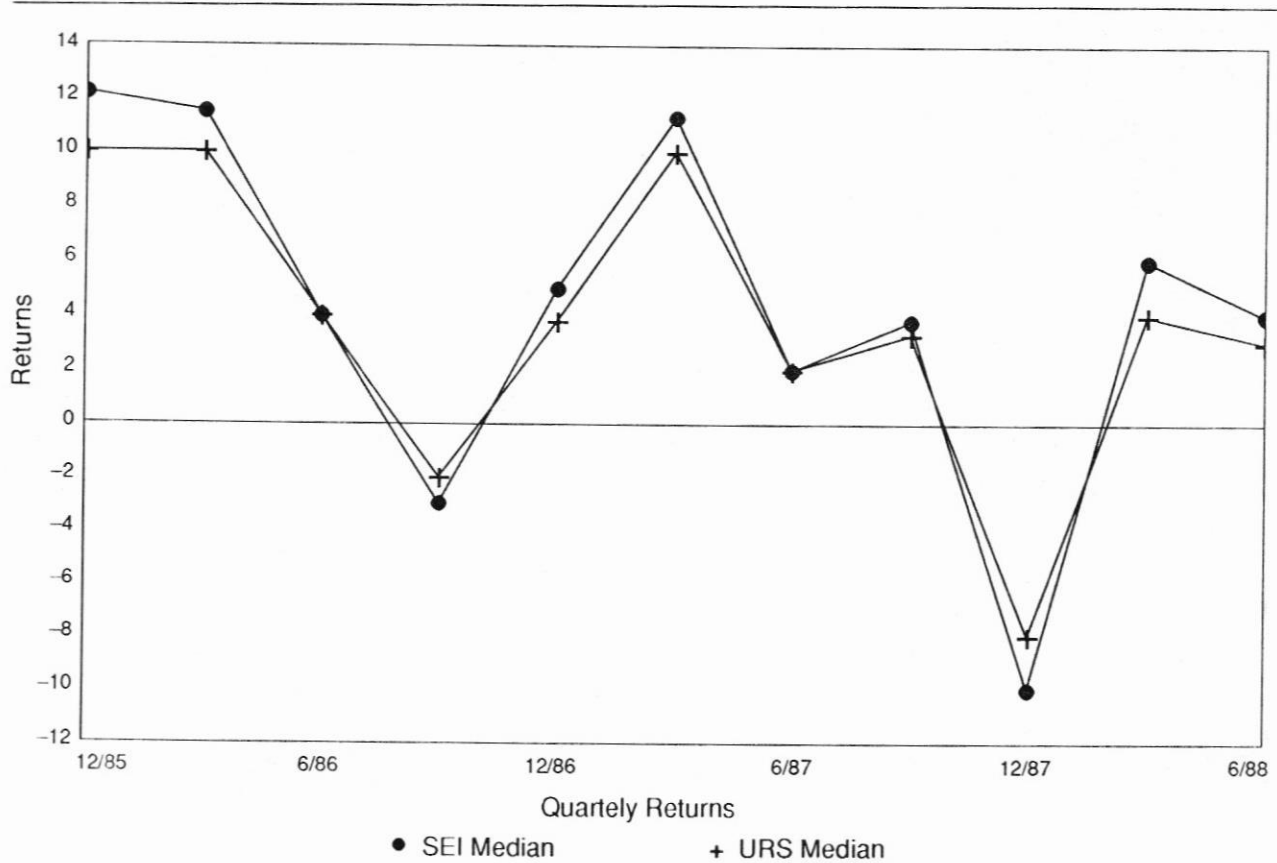
The last five-year period shows improvement in portfolio investment returns. Improvements are a result of the board's decision to increase fund allocation to equity and move away from other investment classes. This action coupled with recent aggressive action with equity money managers (discontinuing the services of some and reducing the amount of funds held by others) should lead to higher returns with some greater risk. However, returns over the last five year period appear low compared to funds with similar risk.

URS Risk/Return Is Low Compared To Other Funds

The URS total fund has a lower risk level than most investment funds included in SEI's evaluation. The URS goal is to keep overall portfolio risk below 14 percent as measured by standard deviation of returns. Utah averaged between 9 and 10 percent according to SEI data which shows standard deviation returns over the last five years. Thus, URS was within the fund's goal for risk. According to our consultant, while opportunity costs of low returns are substantial, there is no compensating benefit from the achievement of lower than targeted standard deviations in returns. Given that inflows to the URS exceeded outflows on the order of four times, there was no need for liquidity. Therefore the achievement of below 10 percent standard deviation in returns instead of the targeted 14 percent was of no value to URS participants.

Since URS risk level was low, fund performance should be better during bear markets and worse during bull markets compared to other pension funds. URS performance compared to the SEI median tends to show that this was the case. The following figure shows a two-and-one-half year period of returns for the SEI median and URS.

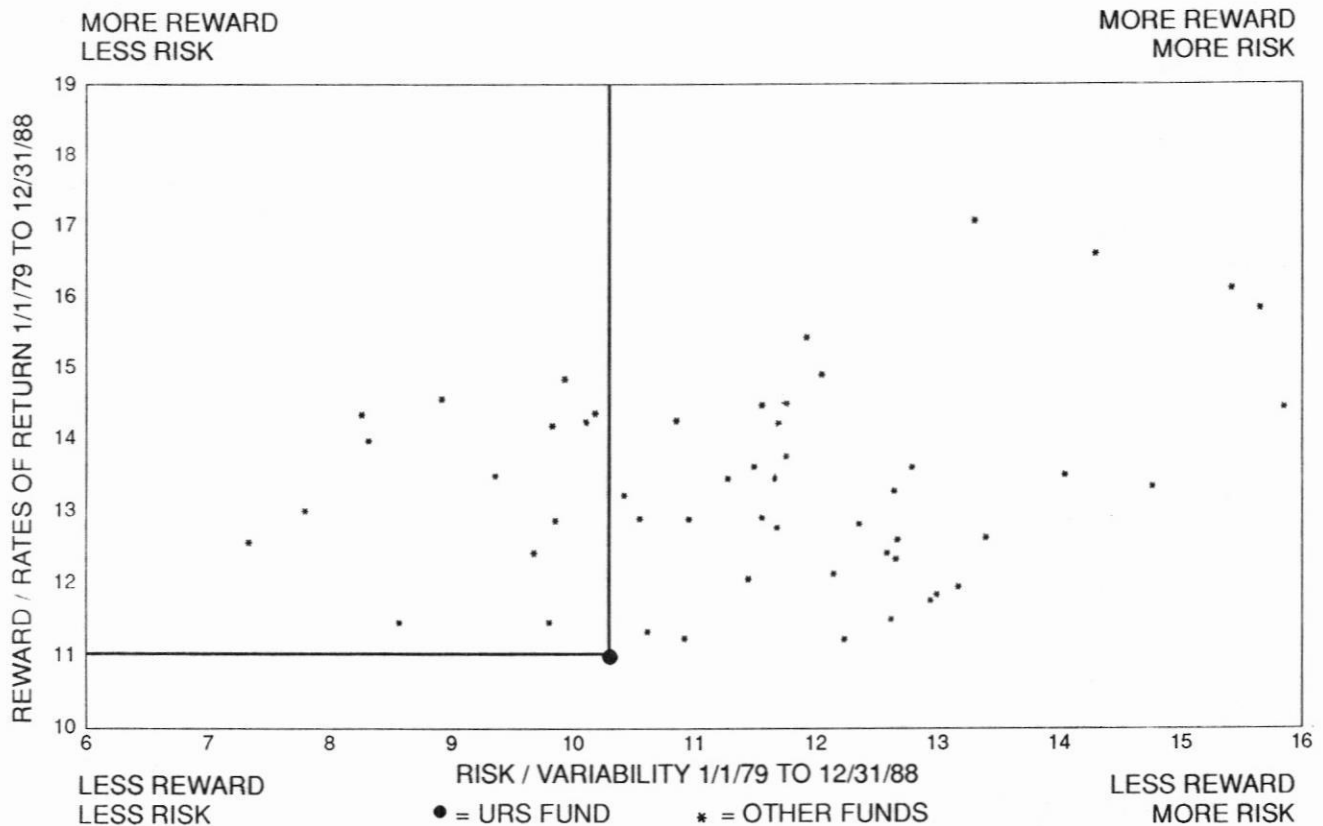
FIGURE XVII
URS Returns vs. SEI Returns



Source: SEI Corporation

Although the difference is small, Figure XVII does show that Utah's fund has slightly underperformed the SEI median during bull markets but has not fallen as far during bear markets since 1985. Historically, markets trend upward with funds with a higher risk level tending to outperform funds with lower risk over a long period of time. The higher risk is usually created because of a higher exposure in stocks which have greater variability in returns. But the URS fund has not performed as well as most funds with equivalent or lower risk. Figure XVIII shows the relative position of URS on risk and return compared to the position of other funds over the past ten years as reported by SEI Corporation.

FIGURE XVIII
Reward vs. Risk Analysis
URS Compared to Other Pension Plans
Ten-Year Period

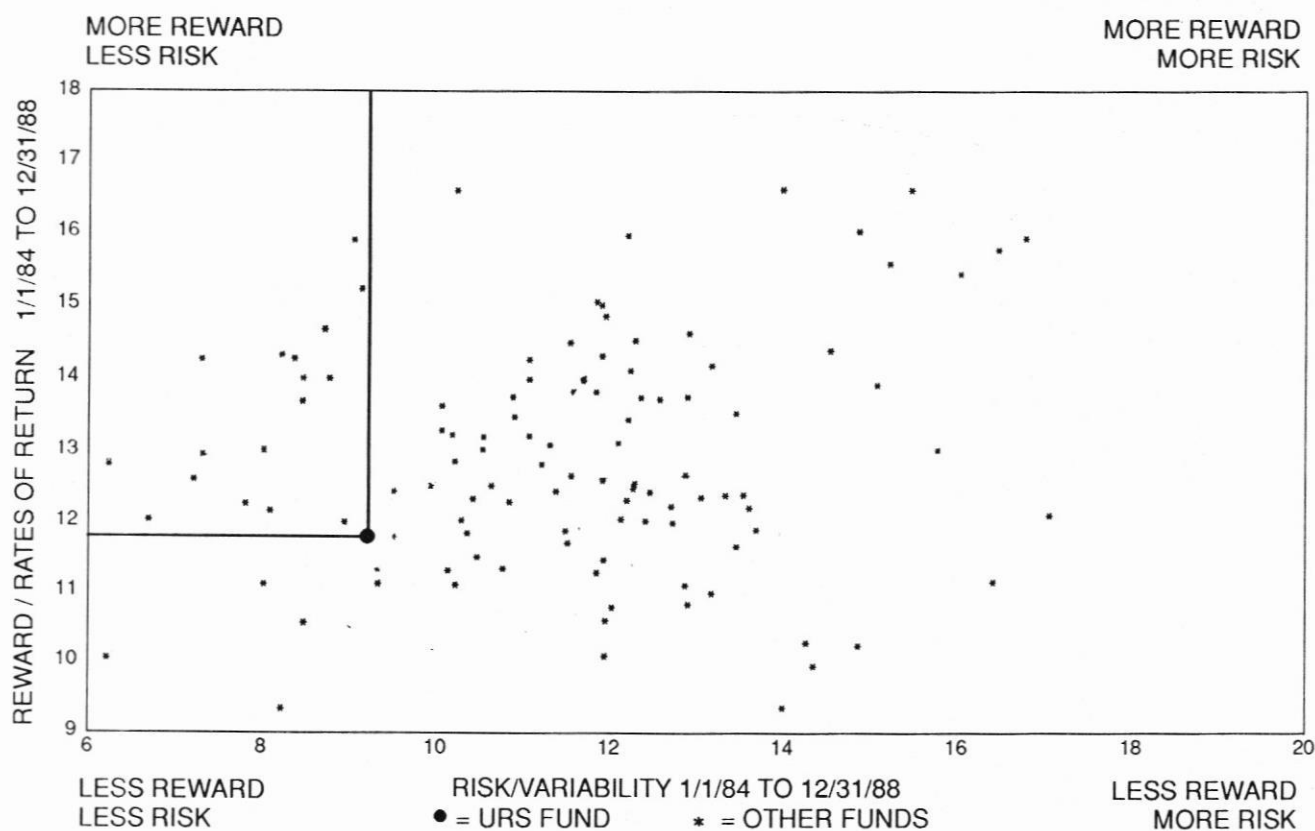


Source: SEI Corporation

Over the past ten years the URS fund has achieved lower returns for the same risk level as other funds. Several other funds with similar or lower risk had higher returns. The next figure shows URS risk and returns compared to other funds over a five-year period.

FIGURE XIX

**Reward vs. Risk Analysis
URS Compared to Other Pension Plans
Five-Year Period**



Source: SEI Corporation.

Figure XIX shows that URS had a somewhat better return for the risk level over the last five years compared to the last ten. However, there were still more funds with similar or lower risk which outperformed URS. The market over the last five years was unusual in that funds with high risk did not necessarily have higher returns compared to lower risk funds. Therefore, it is difficult to conclude that URS return is appropriate for its risk level, although the graph does indicate it has improved over the last ten years.

Equity Money Managers' Risk Exposure Is Within Guidelines

SEI also assesses risk exposure by the various equity managers of a fund. URS equity managers all were within URS guidelines for

the level of risk as measured by the established standard for each equity manager. Since risk should be evaluated in consideration of the overall portfolio, the higher risk exposure by some equity managers and in the S&P 500 Index does not concern us but needs to be considered as assets are being allocated. The risk standard for equity managers will vary due to each managers investment style. Figure XX compares the risk level of various equity managers to the URS established standard.

FIGURE XX

**Risk Analysis by Equity Manager
Jan. 1, 1984 to Dec. 31, 1988**

Equity Manager	Risk Level*	URS Standard
External Funds:		
Smoot/Miller	7.54%	9.17%
Value Line	7.89	11.67
Atalanta	11.12	11.17
Public Employees	7.84	9.17
Wasatch	10.38	11.67
Internal Funds:		
Index Fund	10.62	9.17
Internal Stock	9.10	9.17
Stock/Growth	5.70	11.67

*Based on annualized standard deviations.

Figure XX shows that nearly all the funds were within the allowed risk standard. Some equity managers do maintain a higher risk exposure in the attempt to get higher returns. However, proper diversification by URS tends to maintain a low risk exposure for the total fund.

The URS board recently took action because of the fund's low equity performance. The board discontinued the services of one outside manager and discontinued the two actively managed internal equity funds. The board also reduced the amount of funds handled by the equity managers discussed in this report. As previously mentioned, recently hired equity managers were not evaluated in this report. The Board has authorized increased funds to the S&P 500 index fund as well as a search for some additional money managers. In addition, our consultant agrees with the URS fund's move into international investments. The international fund should provide higher returns with no more portfolio risk, if managed properly.

Chapter VI

REAL ESTATE INVESTMENT RETURNS ARE LOW

As mentioned in the previous chapter, URS real estate investment returns are low. They are substantially lower than average returns reported from three other real estate indices we used to compare with the fund's performance. Our audit estimates that URS could have gained an additional \$32 million over the past two years had its real estate portfolio performed at the average of the other indices. These gains would have been in both income and appreciation of property with most of the increase in the appreciation of property values. Low returns on raw lands and on income properties managed externally have lead to the portfolio's poor performance.

In our 1982 audit of URS' real estate investments, we reported examples of raw land and income property purchases which were made without adequate investment analysis. Our current audit reveals that these properties, purchased prior to our initial audit and still being held by the fund as of 1987, account for about 40 percent of the fund's \$32 million substandard performance. The other \$19 million in additional potential gains is traceable to properties acquired and managed by FIA Associates, an external manager who was hired by the fund in 1983. Recent real estate acquisitions made by the current real estate officer have performed above market, indicative of improved acquisition policies and analysis made by URS.

Although real estate investments have generally yielded lower returns than stocks and bonds in the 1980s, pension fund managers continue to invest in real estate to provide portfolio diversification and a hedge against inflation. Many large public and private pension funds have set a minimum goal of investing 10 percent of their fund's assets in real estate. URS has also targeted 10 percent of its investment funds to real estate. At the end of 1988, about 8 percent of the fund's \$3.2 billion in total assets based on market value was invested in real estate equities. Compared to other investment vehicles, real estate is a less liquid asset, generally requiring longer holding periods than other investments to produce results.

This chapter is divided into two sections. First, returns on URS real estate portfolio are compared against three other real estate market indices over one-, two-, and nine-year investment horizons. Second, real estate investments in the portfolio are classified by acquisition manager in an effort to identify which investments are lowering performance.

Real Estate Portfolio Has Consistently Underperformed

The URS real estate portfolio has consistently underperformed three other large real estate indices from both a short- and long-term investment horizon. Compared to the market index used by URS' real estate consultant, Institutional Property Consultants (IPC), the portfolio's total net return over a one-, two-, or nine-year history ranks in the lowest quartile of the benchmark. An additional \$32 million could have been added to the fund in 1987 and 1988 alone if investments in the portfolio had performed up to the benchmark average. No attempt was made to measure potential earnings over a longer period because of the large amount of time required to collect and analyze the data. Current management is not responsible for most of the portfolio's low returns; rather, write-downs in market values on the fund's raw lands which were acquired by former management in the early 1980's and income properties purchased and managed by one external real estate manager account for most of the lower earnings.

The average annual returns earned on real estate portfolios of public and private pension plans in IPC's benchmark track fairly closely with annual returns reported by two other large real estate indices, the Frank Russell Company Property Index (FRC) and Evaluation Associates Index (EA). Figure XXI compares the long-term performance of the URS portfolio against those of the three real estate indices. The annual returns listed in the figure represent average time-weighted total rates of return. URS returns on its raw lands and fixed-income properties are not included in the comparison. If included, URS portfolio's performance would be even lower than represented in Figure XXI.

FIGURE XXI

Long-term Comparison of URS Portfolio Returns with Market Indices 1980-1988

Year	URS Portfolio ¹	IPC Index	FRC Index	EA Index
1980	6.1%	18.0%	18.1%	20.4%
1981	9.2	17.2	16.9	20.1
1982	14.6	12.3	9.4	13.0
1983	9.2	13.1	13.2	14.3
1984	11.9	12.8	13.1	13.4
1985	10.7	10.9	9.8	12.0
1986	1.6	8.0	6.4	9.1
1987	-2.2	6.2	5.3	7.2
1988	3.1	6.8	7.1	8.1
last 2 yrs average	0.5%	6.5%	6.2%	7.7%
last 9 yrs	7.1%	11.7%	11.0%	13.1%

¹ Returns on portfolio do not include raw lands and fixed-income properties.

For purposes of comparing performance, we decided that the IPC index provided the best measure of the real estate market. We found good comparability between this benchmark and URS' portfolio in terms of property types, investment values, ownership structure, and investment life cycle. Furthermore, IPC assured us that returns are measured in the same manner for the benchmark and the portfolio.

As indicated in Figure XXI, URS' real estate portfolio consistently underperformed IPC's index average. In only one of the nine years evaluated (1982), did the portfolio outperform the benchmark. Irrespective of whether short-, intermediate-, or long-term performance is compared, average returns on URS' real estate investments ranked in the lowest quartile among public and private pension funds comprising IPC's index. The average net return on URS' portfolio during the nine years was 7.1 percent, while the benchmark average was 11.7 percent. Similar results emerge when the most current one- or two-year comparisons are made.

IPC does not include returns on the fund's raw lands and fixed-income properties in its quarterly and annual performance comparisons because other portfolios comprising its benchmark hold few, if any, similar assets. The raw land and fixed-income properties represent approximately 20 percent of URS's real estate market value, which IPC does not evaluate. A fixed-income property refers to a promissory note held by URS on a property it sells to a buyer through a mortgage arrangement. The portfolio's average returns would be lower if these types of investments were included. For example, in 1988 we calculated that the aggregate net return will drop from 3.1 percent as reported by IPC to 1.3 percent when raw lands and fixed-income properties are included.

The poor performance of the real estate portfolio relative to IPC's benchmark translates into a large shortfall. If URS real estate performance had been up to the average of portfolios in the benchmark, additional gains would have been realized. At year-end 1988, the market value of the total real estate portfolio was \$236 million. Every 1 percent decrease in the portfolio's total returns relative to the benchmark translates into nearly \$2.4 million in additional earnings not realized by URS. Potential additional earnings for 1987 and 1988 are shown in figure XXII, classified by property type and manager. We estimate that URS, by consistently underperforming the market over the past two years, experienced a shortfall of \$32 million.

FIGURE XXII

Estimated Additional Earnings of URS Real Estate Portfolio Aggregates Relative to Benchmark Average: 1987-1988

Property Type/Manager	Estimated Earnings (Under)/Over*	1988 Ending Market Value
FIA Associates	(\$19,792,000)	\$76,522,000
URS-Raw Lands	(8,852,000)	17,470,000
URS/FIA Associates	(4,084,000)	11,730,000
Aetna	(8,000)	3,927,000
URS-Income Properties	8,000	76,185,000
URS-Fixed Income	164,000	28,509,000
JMB Group Trust	<u>406,000</u>	<u>21,694,000</u>
Totals	\$(32,158,000)	\$236,037,000

*Estimates include both income and appreciation of property.

As the data in Figure XXII indicate, three components of the portfolio account for URS' poor performance in 1987 and 1988: 1) income properties acquired and managed by FIA Associates which is a major component of the shortfall, 2) raw lands purchased and managed by URS, and 3) income properties purchased by URS that were later transferred to FIA in 1983. By far the largest potential losses stem from 10 properties acquired and managed by FIA Associates. During the past two years these income properties, consisting principally of shopping centers, office buildings, and industrial buildings located outside Utah, have experienced reductions in appraised values of more than \$18 million. FIA acquired these properties with board approval during the years 1984 through 1987 with URS real estate staff raising concerns over FIA's practices as early as 1984. These large write-downs in market value have offset net income generated by the properties, resulting in low yields of 0.2 percent in 1988 and a negative 7.2 percent in 1987.

Similarly, the raw lands portfolio and the properties transferred to FIA have underperformed the market, mainly because of large unrealizable losses on appreciation. These properties were generally purchased prior to 1982. During 1987 and 1988, net write-downs in market values on raw lands totaled more than \$6 million. These undeveloped properties produced negative returns of 22.5 percent in 1988 and 5.2 percent in 1987. Four income properties purchased by URS and transferred to FIA in 1983 were written down \$920,000 over the two-year period. Losses on appreciation and on income resulted in negative returns of 9.9 percent in 1988 and 10.2 percent in 1987 on these four investments alone.

The URS board and the real estate staff are aware of the low returns earned on its raw land portfolio. As early as 1983, URS recognized that it was one of the few public pension funds having a large component of raw lands in its portfolio. It adopted the strategy to sell off its undeveloped lands. One of the reasons FIA was hired by the fund in 1983 because it offered the best marketing plan for these undeveloped properties. When FIA failed to initiate a single sale in the 16 months it managed the assets, the raw land portfolio was transferred back to URS staff. The URS staff have sold approximately one-third of the raw land then in 1988, URS hired a listing broker to continue to aggressively market these properties. The broker has consummated two sale to date. To facilitate sales of these properties, which have been held an average of 8.5 years, the board has approved a policy to price the lands at their appraised "fair values" rather than their appraised market values. Market value represents the most recent or average of the most recent appraisal values. Fair value is that value which results from discounting the appraised value by the amount necessary to promote a "quick" sale of the property, generally within the next 12-month period. URS has established fair values on its raw lands that average about 11 percent less than current market values.

Total returns on real estate consist of appreciation and income. Appreciation refers to changes in market value. For example, an investment purchased for \$1 million, which is later appraised at \$500,000 shows an unrealizable loss of \$500,000 in appreciation. Income or net income is the difference between revenue and expense. Generally, raw lands will produce negative net income because carrying costs for utilities, property taxes, insurance, and management fees will be larger than revenue derived from leases and other sources. The properties are purchased with the expectation that their increase in appreciation will more than offset the costs to hold the asset.

The URS board together with its real estate consultant is investigating possible reasons for FIA's poor performance to determine what corrective action should be taken. When the investigation is completed, the board will decide whether to retain FIA or to select another advisor. The URS board should continue to evaluate real estate performance and consider ways to improve returns.

Recent Real Estate Investments Show Improved Performance

Although overall real estate returns have been low, real estate investments made since 1985 show higher returns than earlier investments. Improved acquisition policies and investment analysis have been instituted by URS to assess the investment's return and risk potential. URS has discontinued the speculative practice of purchasing undeveloped lands. In addition, URS has recently elected to invest in commingled funds. These funds together with recent acquisitions have outperformed the market.

Compared to stocks and bonds, real estate represents a much less liquid investment vehicle. This lack of liquidity is reflected in the fact that a majority of the current properties in the fund's real estate portfolio were purchased prior to 1985. Figure XXIII lists the various internal and external acquisition managers, their periods of tenure, and the number and market value of properties they acquired that were still in the portfolio as of December 31, 1988.

FIGURE XXIII

Portfolio Aggregate by Acquisition Manager End of 1988

Acquisition Manager	Period of Tenure	Number of Properties	Book Value of Properties
Internal #1	1985-present	3	\$44,100,287
Internal #2	1981-1984	15	61,801,585
Internal #3	1975-1980	36	30,447,635
FIA Associates	1983-present	10	110,431,299
JMB Group Trust	1987-present	Commingled Fund	20,000,000
Aetna Realty Inv.	1987-present	Commingled Fund	<u>3,836,700</u>
Totals		64 plus 2 Com Funds*	\$270,617,506

*URS acquired interest in a third closed-end commingled fund at the end of 1988. This purchase is not included in the above table.

During the 14 years URS has invested in real estate (1975-1988), three different investment officers have managed the internal portfolio. URS has also contracted with three outside advisors to manage and acquire investments. Besides FIA Associates, the fund has contracted with JMB Group Trust and Aetna Realty Investments, two closed-end commingled funds. Under the commingled fund arrangement, URS divests itself of any responsibility for purchasing, managing, or selling decisions at the property level. As shown in figure XXIII, 50 percent of the portfolio's nearly \$271 million in ending 1988 book value was acquired by outside advisors to the fund.

A comparison of 1987 and 1988 net rates of return on properties grouped by acquisition manager is summarized in Figure XXIV. The worst performing properties were acquired under the direction of the real estate officer who managed the portfolio from 1975 through 1980, when most of the raw land in the portfolio was purchased. The highest yields are on properties acquired recently by the current real estate officer and the commingled funds. These investments have performed equal to or better than the IPC benchmark over the short history available on these investments.

FIGURE XXIV

Net Rates of Return by Acquisition Manager 1987-1988

Acquisition Manager	Time With URS	Net Rates of 1987	Return at Market 1988
JMB Group Trust	1987-present	NA	9.0%
Internal #1	1985-present	6.7%	7.1
Aetna Realty Inv	1987-present	NA	6.7
Internal #2	1981-1984	-0.5	4.4
FIA Associates	1983-present	-7.7	1.3
Internal #3	1975-1980	-8.5	-18.6
IPC Index		6.2%	6.8%

Improved acquisition policies and investment analysis have been instituted by URS. Following the recommendations of our previous audit report, the URS board began to establish criteria and objectives for the purchase and sale of real estate. In 1988, these criteria were revised by IPC. The new policy prohibits the assumption of undue risk, demands investment diversification by geographical area, by investment structure, and by property life-cycle stage, and requires predictable investment performance based on realistic economic projections and past income earned. In addition, the purchasing decision requires a market area analysis of the property's economic and demographic characteristics, a review of rental rates of similar properties in the market area, and valuation requirements for the sale of the property. The approval of the purchase or sale of an investment requires the unanimous consent of the Real Estate Investment Committee, which is comprised of the executive director, investment officer, and real estate investment officer. The URS board no longer reviews or approves property acquisitions or dispositions.

Current real estate policy does not prohibit URS from purchasing undeveloped properties in the future. However, return requirements are so high, that few if any investments considered for purchase would qualify. It is doubtful if any of the raw lands acquired previously would meet current investment criteria, under which the required annual rate of return is 21 percent for such speculative investments. URS made its last major acquisition of undeveloped land in the early 1980's. Since then, the fund has sold approximately one-third of its raw land portfolio. It had 42 land properties in 1983 worth \$35.4 million at book, and at the end of

1988 it had 22 land investments with a book value of \$21.6 million. The sold lands averaged a very respectable internal rate of return of 12.3 percent. However, returns for the remaining properties are expected to be much lower due to the large market write-downs taken and the high carrying costs associated with the assets.

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Chapter VII

BUILDING SPACE UTILIZATION LACKS PROPER CONTROLS

Although the state and many private institutions have building space requirements for employees, URS does not use any space requirements or controls. As a result, space allocations significantly exceed space standards established for state agencies, and URS building space is not well utilized. Proper utilization of a building would prevent trust money from being used to provide and operate unnecessary building space. Our review showed both that URS space utilization is low compared to other state office buildings and that URS private office sizes exceed state standards.

The URS' existing building could be better utilized if proper controls over building use were in place. Approximately 140 employees are housed in the McDonald Building. If URS were to comply with state building standards, a larger number of employees could have offices in the structure. Inefficient use of space in the McDonald Building may have resulted in URS leasing over 6,000 square feet of space in a nearby office building as well as receiving board authority to build a new office expansion with over 60,000 square feet of rentable space next to its existing building.

Estimated construction costs for the new building in the original contract totaled \$3.7 million excluding the cost of tenant improvements (\$811,087) and land value (\$947,798). The developer using a May 26, 1989 proposal revised these costs upward from \$3.7 million to \$4.4 million, due to plan changes and conditions imposed by the Salt Lake City Planning & Zoning Commission. The developer estimates cost increases in the following areas:

1. Full basement	\$315,800
2. Unfinished racquetball courts & exercise facility	150,000
3. Parking structure	102,180
4. Rear entrance canopy	55,150
5. Architecture & engineering	39,500
6. Contingency fee adjustment	38,420
7. Air conditioning adjustments	32,080
8. Pocket park landscape	31,250
9. Tunnel	28,120
10. Power line relocation	20,450
11. Bid adjustments	<u>(130,000)</u>

Building revision costs	\$682,950
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The new building will be classified initially as an investment asset since it is anticipated that about 80 percent of its rentable space will be leased to outside tenants. In time, as URS occupies a larger percentage of the 61,000 square-foot rentable area, the structure will be reclassified as an internal operating asset. This approach does not require budgetary review and approval by the State Legislature. URS projects it will need 10,000 square feet of initial space and an additional 5,000 square feet each successive year. These growth projections are not supported by URS existing plans for additional staffing needs.

URS Space Utilization Is Low Compared to Other State Office Buildings

URS usable square footage per employee is 30 percent higher than the average of other state office space we sampled. The higher space allocation per employee suggests that space in the McDonald Building could be better utilized. More efficient use of existing space would significantly decrease URS need to lease or construct additional office space.

Space utilization varies with building design and agency needs. For example, 29 percent of the McDonald Building is common space (such as bathrooms, hallways, lobby, and lunch room). Most other office buildings owned or leased by the state have common areas representing 11 to 17 percent of rentable space. The high common area of the McDonald Building is a result of how the architect designed the building, not a measure of URS use of existing space. In order to make a fair comparison of how well existing space in the McDonald Building vis-a-vis other state office buildings is being used, we eliminated common areas from surveyed structures and only included usable space, the actual area occupied. Figure XXV shows how four state buildings' usable space (excluding such space as elevator shafts, stairways, halls, foyers, atria, and lunch rooms) compares to URS usable space.

FIGURE XXV

URS Usable Space Compared to Other State Office Buildings

Building	Usable Square Feet	Number of Employees	Square Feet Per Employee
Heber Wells	168,001	900	187
Social Service	105,000	620	169
Dept. of Transportation	175,801	700	251
Health Building	138,067	700	197
Average	146,717	730	201
URS	36,660	140	262

Figure XXV shows that while state employees average about 200 square feet of usable space, URS employees are allocated an average of 260 square feet. If URS' space allocation were the same as the survey average, then an additional 42 employees could be placed in the McDonald Building. One reason the state is able to accomplish higher utilization is because it has developed space allocation standards for various types of office space. The next section compares the space allocated to URS employees in private offices against these standards.

URS Private Office Sizes Exceed State Standards

While the state and some private companies have established standards for office sizes depending on an employee's position, URS does not have any standards to limit the size of private offices. We found that its employees' office spaces significantly exceed state standards. If state standards were used by URS, then the existing building could be better utilized. Higher utilization would result in lower unit operating costs.

Although we did not complete a comprehensive space utilization study of the McDonald Building, believing that such a study would require a consultant, we did compare some existing private office space against state standards. Our review of some URS administrative positions and lower staff positions with large room allocations indicates that URS' usable space could be better utilized.

FIGURE XXVI

**URS Space Allocations Compared to State Standards
For Private Office Space**

URS Job Position	State Standard Used	URS Sq. Ft. Allocated	State Sq. Ft. Allowed	Extra Space Sq. Ft.
Investment Officer	Deputy Dir.	245	185	60
Support Svcs. Manager	Deputy Dir.	315	185	130
Controller	Deputy Dir.	280	185	95
Group Insurance Admin.	Deputy Dir.	255	185	70
Admin. Service Manager	Deputy Dir.	265	185	80
DP Manager	Deputy Dir.	220	185	35
Records Manager	Section Head	210	160	50
Portfolio Manager	Professional	200	125	75
Property Manager	Professional	165	125	40
Investment Analyst	Professional	225	125	100
Medical Claims Manager	Professional	245	125	120
Micro Computer Spec.	Computer Spec.	170	100	70
Programmer Analyst I	Computer Spec.	155	100	55
Personnel Assistant	Counselor	200	100	100
General Clerk II	Clerk	160	60	100
Records Analyst I	Technician	150	75	75
Totals		3,460	2,205	1,255

As the comparisons from Figure XXVI indicate, URS private office space allocations to employees significantly exceed state standards for similar positions. Even some URS clerical positions are allocated more space than professionals in private or public office. Based on these 16 selected positions, URS employees average one-and-one-half times more space than recommended by standards -- almost 80 additional square feet per work station. This analysis suggests that existing space can be more efficiently used.

Undoubtedly, increased utilization of the McDonald Building may not be cost effective because remodeling costs in some areas of the building might run as high as \$20 a square foot. But this cost would have been cheaper than constructing a new building, where projected costs are around \$100 a square foot. Moreover, better utilization of the existing building is necessary to lower operating costs figured per employee.

Proper discharge of management's responsibility should entail appropriate utilization of existing building space. Without a utilization study and without appropriate space standards in place, there is no assurance that expansion into the new office building will be handled efficiently. Also, improved utilization of office and common space in the McDonald Building should be examined to make more space in the new building available as income property. In our opinion, the new building should never have been built without a space utilization study.

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Chapter VIII

TRAVEL EXPENSES LACK PROPER CONTROLS

The lack of proper controls in URS travel policy and procedures has resulted in comparatively high out-of-state expenditures and double reimbursements. Although URS compensation is higher than market, employees are allowed additional income through travel reimbursements. Travel policies of most other public pension plans provide adequate assurance that travel expenditures are reasonable and that reimbursements are for expenses incurred. However, URS out-of-state travel policy does not assure adequate control over travel expenditures and the amount of travel incurred. As a result, URS out-of-state travel expenditures averaged \$31,400 higher than those of other retirement systems surveyed. Additionally, proper controls do not exist to assure appropriate documentation for reimbursed business meals which appear high.

URS Out-of-state Travel Expenses Are High

URS expenses for out-of-state travel are higher than those for funds in other states. During fiscal year 1988 the URS system spent approximately \$65,250 on out-of-state travel. This figure is significantly higher than the average expended by nine other state retirement systems (\$33,850). The URS system averaged \$31,400 higher than the other funds surveyed. It appears that URS could reduce their travel expenses by allowing fewer trips and not allowing double reimbursements.

The funds of nine states were selected for our survey of travel expenses. The funds were selected on the basis of their western location or on their asset size. We concentrated more on larger sized funds because URS staffing levels are typically higher than those of funds with a similar sized asset base. Figure XXVII shows the states surveyed, asset size, membership, and employees.

Multiple Retirement Programs
of FTE's AS compared to OTHER.

FIGURE XXVII

URS Out-of-state Travel Expenses
Compared to Other State's

Retirement System	Asset Size* (Billions)	Total Membership	Number of Employees	FY 1988 Travel Expenditures
Arizona	\$6.2	166,000	62	\$ 10,000
Colorado**	7.6	136,000	138	141,400
Idaho	1.3	59,300	44	13,000
New Mexico	1.5	35,000	41	15,000
Nevada	2.7	89,000	37	21,100
Georgia	2.9	250,000	36	12,800
Mississippi	3.3	174,000	73	40,500
Iowa	3.8	195,000	51	40,000
Kansas	3.2	147,000	65	10,800
Average	\$3.6	139,100	61	\$33,850
URS	\$3.2	104,100	101	\$65,250

*Asset size taken from Pension and Investment Age Magazine, 23 Jan. 1989.

**Estimated out-of-state travel since Colorado does not account for out-of-state travel separately and includes travel by employees involved in Colorado's health program.

Figure XXVII shows that only one fund, Colorado, has a higher expense for travel than Utah. The table also shows that Utah has a higher number of employees on average, although the fund's asset base and membership is lower on average. Since the URS personnel system lacks proper controls it is not possible to conclude that the higher travel is justified by the high number of employees. However, even using travel costs per employee rather than membership or asset size, URS travel is still over 16 percent higher than the average.

URS fiscal year 1988 out-of-state travel expenses amount to over \$65,250. These travel expenses included expenses which are charged to the investment fund and are not subject to the normal budgetary review of the Legislature. Approximately \$11,000 of the \$65,250 travel expenses were to send eight URS employees and four board members to an annual real estate conference which URS sponsors. Revenue from this conference is used to pay these expenses and is kept in a separate account. Currently, this account has in excess of \$80,000.

A review of out-of-state travel vouchers indicates travel expenses can be reduced by other ways than limiting out-of-state travel. An example of a possible savings is a trip made by an employee to Orlando, Florida for training. The same training was available closer to Salt Lake City during various time periods. The training lasted four-and-one-half days and lunches were included in the registration fee. The employee, however, submitted meal reimbursement for seven days and did not exclude the lunches already covered by the registration fee (see next section). In addition, the employee stayed at the conference hotel but still rented a car which was paid for by URS. The car rental, double reimbursement for meals, and location all could have been avoided, thus reducing the cost of this trip.

URS Double Reimburses Employees For Meals

Another area in which travel policy lacks controls is that of meal reimbursement. URS policy allows travelers to be reimbursed for meal expenses which they did not incur. URS employees often do not have to buy meals. URS will send several employees on trips to conferences, training, or seminars which often include meals in the registration fee or the meals are paid for by a third party. In addition, administrators and board members receive many invitations to meals and other activities. However, URS policy allows for employees to be reimbursed for these meals, resulting in income to the traveler. During calendar year 1988, 49 of 93 travel vouchers had documentation of some meals provided. The 49 trips showed at least \$2,359 of meals were provided. URS reimbursed the full amount of \$5,192, resulting in a double reimbursement for expenses and employees' receiving additional income from travel.

The state of Utah has established a meal per diem which closely reflects the actual cost of meals. However, since the per diem rate closely reflects costs, state employees must deduct provided meals from the per diem rate. The state recently raised the per diem rate to \$30 a day for out-of-state travel. In addition, other retirement systems either reimburse actual costs or use a per diem rate which reflects actual costs. Other public retirement funds that use a per diem rate require meals provided in the conference fees to be deducted from the per diem to avoid reimbursing employees for expenses not incurred.

The URS per diem rate of \$30 is similar to the state's, which is supposed to reflect the actual cost of meals. However, unlike state policy, the URS policy allows reimbursements for expenses not incurred. In our opinion, travel rules should be established to provide reimbursement for expense incurred and not provide an additional source of income for employees. For example, the executive director was president of the National Conference of Teacher Retirement (NCTR) association in fiscal year 1987. As

president, he attended a planning meeting in the Virgin Island. According to the NCTR treasurer, all expenses including meals for this trip were paid for by NCTR. However, the executive director still submitted to URS a \$138 travel voucher for meals, which is allowed by URS policy. Since these expenses were not incurred, this reimbursement represents additional income to the executive director. The executive director also has expenses paid as National Association of State Administrator's (NASRA) administrative officer. Since the director is on salary with NASRA and goes on trips which qualify both as NASRA and URS business, the meals paid for through NASRA should not be reimbursed by URS.

It appears travel expense can be reduced through disallowing double payments for meals. During calendar year 1988, it appears travelers received at least \$2,359 in double reimbursements, resulting in additional income from these trips. Since complete documentation and information was not available on travel, there is no way to determine the total amount of meals provided to URS employees.

Business Meal Expenses Inadequately Documented

A final area which lacks proper control is that of allowing and documenting in town business meal expenses. Most public pension plans contacted allow no to little in town business meal expenses while URS averages over \$550 a year. For example, the executive director has not appropriately documented some \$1,100 of business lunches over the last two years. Appropriate business practices would require that business meals be documented as to location, reason, individuals, and amount for the business lunch. However, the URS executive director has submitted only Visa charges to be paid by the fund for meals. Some meals did not have any description of the reason or individuals involved. Thus, the executive director could be treating friends, employees, or family to these meals. The executive director assured us that these meals were for business purposes and that he preferred not to disclose all the individuals involved in these meetings, although such a disclosure is required to assure expenditures are justified. He has assured us that in the future he will provide proper documentation.

Chapter IX

RECOMMENDATIONS

The audit report provides direction for improvement in four operational areas and considers URS investment returns. Specifically, we found a general lack of controls in personnel, payroll, building utilization, and travel. Management has already begun taking corrective action to assure proper controls over these expenditures are in place. In addition, we have evaluated the investment portfolio returns and tried to explain why URS returns are lower than the SEI median based on several other investment funds returns. In our opinion, the URS board and URS management has taken action in trying to increase URS returns. These actions include starting the Standard and Poors 500 stock index, investing in international and small capital stocks funds, increasing the asset allocation to equities/stocks, and selling off raw land included in the land portfolio. URS actions should result in improved returns to members of the trust fund. Specifically, the following recommendations are made for the URS:

1. We recommend that URS Board take action to bring total compensation (salary and benefits) back to market and compensation be regularly studied.
2. We recommend that the Board periodically study management salaries to assure internal and external equity.
3. We recommend that the URS discontinue the retention incentive policy requiring the purchase of additional retirement benefits. Employees who have received this benefit should have the expense of the benefit figured in determining future increases in compensation which will result in lower increases to these employees to offset the expense.
4. We recommend that adequate controls be developed over the payroll system. These controls should include a proper separation of duties and procedures to make sure accurate and complete records are maintained according to an appropriate retention schedule. In addition, a timekeeping system should be developed requiring employees to report time worked with proper supervisory review.
5. We recommend that URS keep the Board informed on policy changes and in the impact on administrative expenses.

6. We recommend that payroll procedures be changed to reflect the following policies:
 - A. Leave benefits should be prorated to part-time employees.
 - B. Overtime payments should be properly checked and discontinued to employees who are exempt under federal labor standards.
 - C. Compensatory time should be allowed according to policy and have accurate accounting of compensatory time.
 - D. Leave taken should be accurately accounted for on the employee's records.
 - E. Personal leave policy be used according to well established guidelines.
7. We recommend that the following payroll policies be discontinued:
 - A. Holiday pay for temporary employees.
 - B. Funeral leave for friends.
 - C. Administrative leave for christmas shopping.
8. We recommend proper policies and procedures be developed to assure management and employees do not engage in activities that include working for other organizations during office time and having personal property worked on by URS staff.
9. We recommend that adequate controls be developed over the human resource division which would include:
 - A. Hiring a qualified human resource manager.
 - B. Using competitive hiring practices to seek qualified applicants to fill job openings.
 - C. Establishing controls and guidelines for increases in compensation.
 - D. Conducting Proper job analyses on job positions and updating position descriptions.
 - E. Enforcing nepotism policy.
 - F. Developing a coherent human resource system.
10. We recommend that the Board continue to closely monitor portfolio performance through setting appropriate standards and making changes in fund managers when needed.
11. We recommend that a proper building utilization study be completed and standards be established for job positions.
12. We recommend that travel controls be put in place to prevent excessive travel and that the travel policy be changed to prevent double reimbursement for meal expenses.
13. We recommend that proper documentation and controls be established for business meal expenses.

AGENCY RESPONSE

UTAH RETIREMENT SYSTEMS

UTAH STATE RETIREMENT BOARD

540 East 200 South
Salt Lake City, UT 84102
(801) 355-3884

BERT D. HUNSAKER
EXECUTIVE DIRECTOR

October 12, 1989

Mr. Wayne L. Welsh
Legislative Auditor General
412 State Capitol
Salt Lake City, UT 84114

Dear Mr. Welsh:

This letter is submitted as a response to Report No. 89-11, A Performance Audit of the Utah Retirement Board.

We appreciate the efforts of your audit staff. The audit has been long and arduous for all concerned. The details of the audit have been revealing and will be most helpful to our staff in completing the transition which we have been making in the last few years from a small and relatively uncomplicated entity to the large and rather complex organization needed to fulfill the responsibility which the Utah State Legislature has placed upon us. Time constraints make it impossible for us to make an adequate analysis of the performance audit of our office and we are not able under these circumstances to prepare a detailed response.

However, as you will see from our responses to the specific recommendations of the report, we are in agreement with the fundamental conclusions of the audit and are proceeding to analyze and implement those recommendations.

Below please find our comments on the recommendations of your audit report in the same order in which the recommendations were presented:

1. Management is taking immediate action to address concerns regarding levels of compensation. A freeze on promotions and performance salary adjustments has been put into effect until such time as a proper market survey can be made.

EDWARD T. ALTER, PRESIDENT
HURLEY D. HANSEN, VICE PRESIDENT

LEROY G. FAERBER
DAN MC CONKIE
DAVID R. PINGREE

GEORGE L. MOOSMAN
EDGAR H. THRONDSSEN

2. Management will take steps to make periodic studies of compensation with regard to both internal and external equity.

3. We are reviewing the retention incentive policy with the intention of modifying it and determining actual financial impact on the Fund. If it can be determined that the purchase of service is, in fact, compensation that can be specifically identified, steps will be taken to include it in the consideration of total employee compensation.

4. The payroll function is being segregated from the personnel function to ensure proper controls, and procedures will be reviewed to ensure that proper record keeping is accomplished. Office organizational structure will be changed and timekeeping software will be installed on the computer.

5. It has always been the intent of management that the Board be informed on policy changes and the impact on administrative expense. However, being alerted to your concern that this has not always been done, we will take steps to ensure that this kind of information is always made available to the Board.

6. Implementation of payroll procedures:

A. Policy has already been put in place to specify the conditions under which a part time employee will work, including the prorating of leave benefits.

B. We agree that overtime payments should be checked and discontinued to employees who are exempt under Federal Labor Standards.

C. We agree that compensatory time should be allowed according to policy and should be accurately accounted for. We will take steps to ensure that this happens.

D. We agree that leave time taken should be accurately accounted for. The timekeeping system being put into place should ensure compliance with this regulation.

E. We concur that personal leave policy should be used according to well established guidelines.

7. Discontinuance of payroll policies:

A. Holiday pay for temporary employees will be discontinued.

B. Funeral leave for friends will be discontinued.

C. Administrative leave for Christmas shopping will be discontinued.

8. Policies and procedures will be analyzed and modified to ensure that management and employees do not engage in inappropriate activities during working hours.

9. We concur with recommendation No. 9 in its entirety. We have retained a Human Resource Manager who is qualified in all of the areas mentioned in your recommendations regarding personnel and human resource policy and procedure. He will report for work on November 1, 1989.

10. Policies and procedures regarding investments and asset allocation have been in place since 1985 and we will continue to use the standards outlined in the policy to make continued review and change of Fund managers as needed.

11. We agree that proper building utilization studies and standards should be used. We are in the process of retaining a consultant to do a proper space utilization study prior to the time we make any final commitments of staff to the new building.

12. We agree that neither excessive travel or double reimbursement should be tolerated. We will review our policies to ensure that appropriate modifications are made to comply with this recommendation.

13. We agree that proper documentation and control should be established for business meal expenses, and current policy will be reviewed and modifications made, where necessary.

As you will note, we have taken positive steps to address some of the problems raised in the report. However, under the circumstances imposed by time constraints, we reserve the right to question particular assumptions in the report or specific statements or conclusions which can reasonably be interpreted to support a charge of breach of fiduciary duty.

In summary, we feel that the bulk of the concerns with regard to compensation and other issues regarding personnel and human resource management can be addressed by the hiring of a professional human resource manager. As has been mentioned, that hiring has now been accomplished. Concerns expressed by your report regarding low

investment returns we feel are being addressed by current policy. Reports from our consultants would indicate that the upward trend in investment performance should continue. We will, however, continue to review our controls and procedures both in the human resource area and the investment area to ensure that our fiduciary responsibility is met.

To the extent that the audit has pointed out areas of needed improvement, we are grateful.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "Bert D. Hunsaker", written over the typed name.

Bert D. Hunsaker
Executive Director

BDH:whm

10-18-89

Copies of Studies on Utilization for new bldg.

- AS investment vehicle.
- Burt's Relatives - \$12-13k per yr - Burt said part time -
- Will Budget request change based on audit?
- Line item control
- Bono reviews budget.
- Car allowance - recorded on W-2's?
Burt 10-15k miles
yes -
- Sen. McAllister - why weren't Salaries brought
into line prior - at request of Appropriation
Committee.
- Why have a consultant study if we don't like results.
- # of Employees as compared to other Retirement Systems.
correlate to FTE increase request.