

REPUBLIC OF PALAU
CIVIL SERVICE PENSION TRUST FUND

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2016

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Board of Trustees
Republic of Palau Civil Service Pension Trust Fund:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Republic of Palau Civil Service Pension Trust Fund (the Fund), which comprise the statement of fiduciary net position as of September 30, 2016, and the related statement of changes in fiduciary net position for the year then ended and the related notes to the financial statements, and have issued our report thereon dated May 30, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings and Responses (pages 3 and 4), we identified certain deficiencies in internal control that we consider to be material weaknesses.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as items 2016-001, 2016-002 and 2016-003 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Responses as items 2016-001, 2016-002 and 2016-003.

The Fund's Response to the Findings

The Fund's response to the findings identified in our audit is described in the accompanying Schedule of Findings and Responses. The Fund's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deloitte & Touche LLC

May 30, 2017

REPUBLIC OF PALAU
CIVIL SERVICE PENSION TRUST FUND

Schedule of Findings and Responses
Year Ended September 30, 2016

Actuarial Deficiency

Finding No. 2016-001

Criteria: Under the provisions of Republic of Palau Public Law (RPPL) No. 2-26, the Board adopted a Trust Fund Operation Plan (the Plan) which has the force and effect of law and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code.

Condition: The Fund's actuarial valuation has determined that the Fund has a net pension liability of \$215,546,176 which would cause the Fund's fiduciary net position to become negative in 2018. The Fund's Board of Trustees has adopted a formal funding plan to correct the potential funding deficiency; however, the funding plan has not yet been implemented.

Cause: The cause of the above condition is the lack of implementation of the funding plan.

Effect: The effect of the above condition is that the Fund may not be able to meet its benefit obligations.

Recommendation: We recommend that the Fund implement the formal funding plan to correct the potential funding deficiency.

Prior Year Status: The lack of a formal plan to fund the net pension liability was reported as a finding in the audits of the Fund for fiscal years 2014 and 2015.

Auditee Response and Corrective Action Plan:

Name of Contact Persons: Presley Etibek, Administrator/Chief Executive Officer and Everdil Rechebei, Chief Financial Officer

Corrective Action: For fiscal year 2016, the Fund was highly relying on the direct effort of the Republic of Palau National Government through RPPL No. 9-49, the Palau National Marine Sanctuary Act, to correct the funding deficiency through the collection of the Environmental Impact Fee. Based on arrival and departure statistics, total collection for the Fund would have ranged from \$2.5M to \$3.5M annually. This Act was repealed in 2017. The Fund has developed and adopted the Republic of Palau Civil Service Pension Plan Funding Plan in April 2017. The goals of the Republic of Palau Civil Service Pension Plan Funding Plan are: 1) to move this Retirement Fund from an indebted state to a more funded status, and 2) to ensure longevity of the Civil Service Pension Retirement Fund for the current retirees/beneficiaries and current contributors who are the future retirees and beneficiaries. The activities and ideas set forth by this Funding Plan are strategic actions that guide the Board of Trustees and management in moving this Retirement Fund from its current financial state to a more funded program. The main activities and ideas have been identified as follows:

- Provide amendments to enabling act (RPPL No. 2-26) to increase the contribution level from 12% to 20% in the next four years; to increase the mandatory retirement age from 60 to 62; to enact legislation to levy a reasonable administrative fee on benefits; to increase contribution requirement from five years to seven years per 33 PNC 2021; and to lobby Congress to enact legislation to reduce the benefit level.

Proposed Completion Date: Ongoing.

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Schedule of Findings and Responses, Continued
Year Ended September 30, 2016

Interest Receivable

Finding No. 2016-002

Criteria: An effective system of internal control includes procedures to periodically assess and review receivables.

Condition: As of September 30, 2016, the Fund recorded interest receivable of \$4.4 million for ROP National Government's delinquent contributions from prior years. The amount is under dispute and no judgment has been entered as of September 30, 2016. The receivable was reversed through a proposed audit adjustment.

Additionally, RPPL 9-2 requires that remittance taxes collected by the ROP National Government be transferred to the Fund. RPPL 9-46 appropriated \$500,000 to the Fund for payment of interest receivable on ROP delinquent contribution from prior years, of which \$259,900 was sourced from remittance taxes.

Cause: The cause of the above condition is the lack of formal policies and procedures to assess the recoverability of assets and potential noncompliance with RPPL 9-2.

Effect: The effect of the above condition is the misstatement of net pension assets.

Recommendation: We recommend that the Fund establish policies and procedures to assess the recoverability of assets and determine with ROP whether noncompliance with RPPL 9-2 exists.

Auditee Response and Corrective Action Plan:

Name of Contact Persons: Presley Etibek, Administrator/Chief Executive Officer and Everdil Rechebej, Chief Financial Officer

Corrective Action: We have a system in place that tracks and reviews receivables. When payments are received, they offset the interest incurred on delinquent payments in the accounting system; therefore, we have a spreadsheet that tracks the payments received in its full amount. As per RPPL No. 9-46, the amount of \$500,000 was appropriated to the Fund for the purpose of paying the accrued interest payable for the employer contribution amounts not paid. The law further states that the entire amount authorized shall come from local revenues from the remittance tax established pursuant to 40 PNC 1408. The \$4.4M booked in FY 2016 includes lost earnings as indicated on Civil Case No. 12-177. We agreed to reverse this booking until a memorandum of understanding between ROP, Civil Service Pension Plan and the National Government regarding the lost interest amount is reached.

Proposed Completion Date: Ongoing.

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Schedule of Findings and Responses, Continued
Year Ended September 30, 2016

Investments

Finding No. 2016-003

Criteria: Clearing accounts should be reconciled and timely adjusted. In addition, investment accounts should comply with the Fund's General Security Guidelines of a 10% limit (at cost) of any investment manager's portfolio on individual security of any issuer.

Condition: At September 30, 2016, the Fund recorded an investment clearing account of \$2,176,381 which is expected to be zero at fiscal year end. This matter was corrected through a proposed audit adjustment.

In addition, two investment accounts did not comply with the Fund's General Security Guidelines of a 10% limit (at cost) of any investment manager's portfolio on individual security of any issuer.

<u>Account No.</u>	<u>Security Code</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Limit</u>
79965329	SPG	\$ 148,943	\$ 158,156	\$ 139,685
79965334	EPD	\$ 240,932	\$ 199,185	\$ 107,518
79965334	ETP	\$ 192,393	\$ 151,182	\$ 107,518

Cause: The cause of the above condition is the lack of formal policies and procedures related to timely reconciliation of clearing accounts and review of individual investment manager's compliance with the Fund's General Security Guidelines.

Effect: The effect of the above condition is the possibility of misstated investment balances.

Recommendation: We recommend that investment clearing accounts be adjusted and reconciled at fiscal year end. We further recommend that the Fund establish policies and procedures to review individual investment manager's compliance with the Fund's General Security Guidelines.

Auditee Response and Corrective Action Plan:

Name of Contact Persons: Presley Etibek, Administrator/Chief Executive Officer and Everdil Rechebei, Chief Financial Officer

Corrective Action: We reviewed these findings. The accounts in question are of Miller Howard MLP and Adelante REIT. Both are accounts covered by the IPS Non-Traditional/Alternative Investments section of the IPS. As stated in that section: *"The managers of these investments generally are allowed to operate with greater flexibility than most traditional managers..."*. Part of this greater flexibility is less diversification at times, especially in the case of MLPs where the investable universe is smaller, resulting in the "maximum 10% at cost" being exceeded.

With that said, the current reading of the General guidelines does indeed state Every Investment Manager selected must abide by the 10% at cost, as stated in the audit finding. We should have recommended to modify this requirement when alternatives were added in 2015.

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Schedule of Findings and Responses, Continued
Year Ended September 30, 2016

Finding No. 2016-003, Continued

Auditee Response and Corrective Action Plan, Continued:

Corrective Action, Continued:

We recommend to clarify the intent, and to remove the conflict, with the following clarification:

- No individual security of any issuer, other than that of the United States Government, and Alternative Investments, shall constitute more than 10% (at cost) of any Investment Manager's portfolio.

Proposed Completion Date: Ongoing.

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Unresolved Prior Year Comments
Year Ended September 30, 2016

The status of unresolved findings is discussed in the Schedule of Findings and Responses section of this report.