AUDIT REPORT
OF THE
NEBRASKA PUBLIC EMPLOYEES
RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN

JANUARY 1, 2001 THROUGH DECEMBER 31, 2001

NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN

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NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN

BACKGROUND

The Public Employees Retirement Board (the Board) was created in 1971 to administer Nebraska retirement plans for school employees, State employees, judges, and the State Patrol. The Board assumed administration of the retirement system for Nebraska counties in 1973. In 1976, the Board implemented the State of Nebraska Deferred Compensation Plan. This plan is an optional supplemental retirement plan.

The Board has seven members appointed by the Governor, with legislative approval, to five-year terms. Members include:

- Three participants of retirement systems administered by the Board;
- A retired participant of a retirement system administered by the Board;
- Three public representatives who are not State employees or employees of its subdivisions; and
- The State Investment Officer as a nonvoting, ex-officio member.

All appointed members must be Nebraska citizens

The Board meets monthly. Members are not paid, but are reimbursed for their expenses.

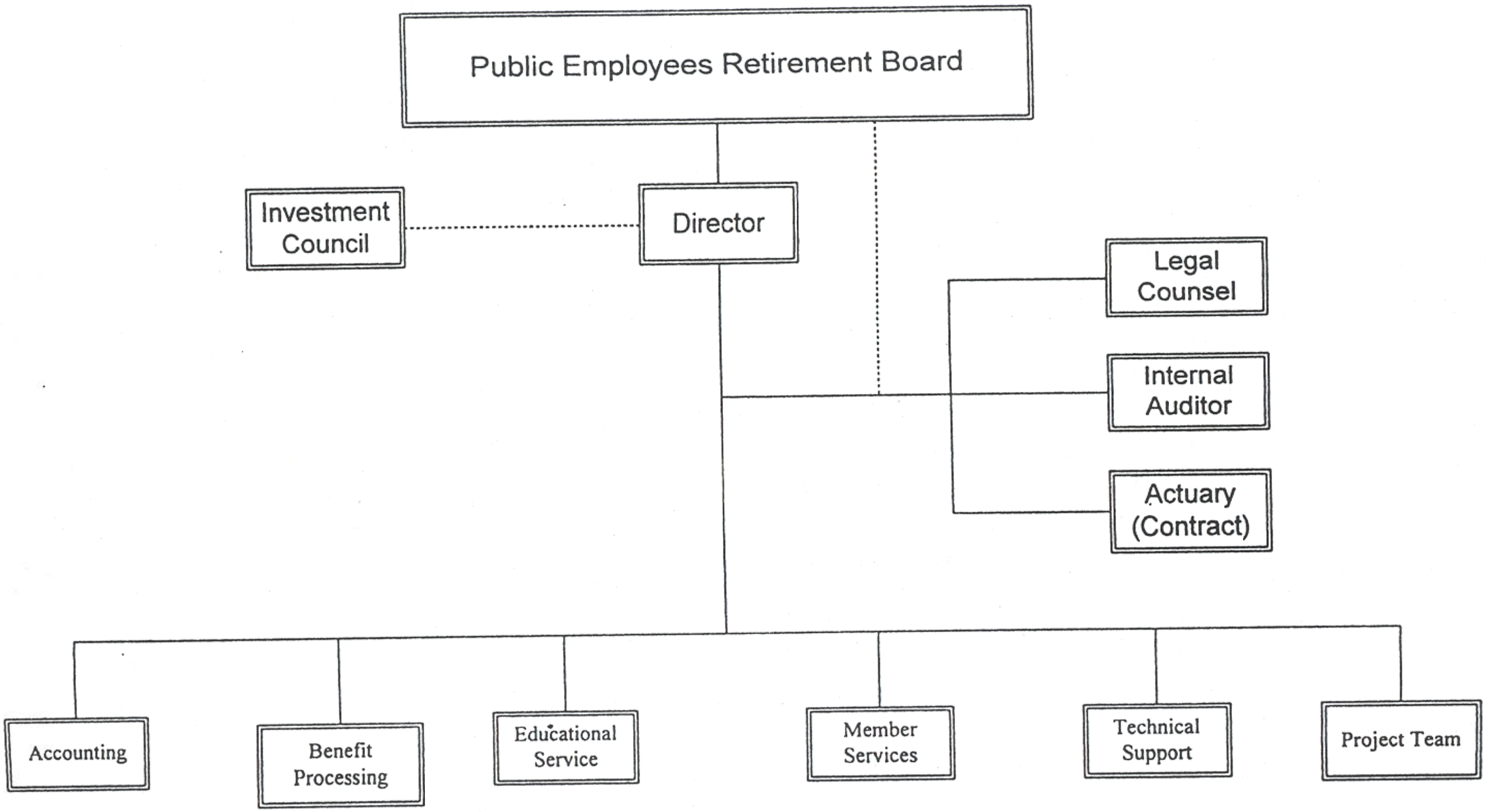
The Board hires a director to manage the day-to-day operations. Expenses are to be equitably distributed among the retirement systems. All expenses must be provided from investment income earned by various retirement funds unless other fund sources to pay expenses are specified by law.

MISSION STATEMENT

The Nebraska Public Employees Retirement Systems recognizes the importance of a successful retirement and is dedicated to providing the highest quality service necessary to assist members in achieving this goal.

NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEM

ORGANIZATIONAL CHART



SUMMARY OF COMMENTS

During our audit of the Nebraska Public Employees Retirement Systems (NPERS) - Deferred Compensation Plan, we noted certain matters involving the internal control over financial reporting and other operational matters that are presented here. Comments and recommendations are intended to improve the internal control over financial reporting, ensure compliance, or result in operational efficiencies.

1. ***Monitoring Hartford Transactions:*** NPERS did not monitor distributions from Hartford Life Insurance Company to ensure payments were processed correctly and in compliance with the Internal Revenue Code.

2. ***Transfer to Another State Plan:*** NPERS did not have procedures to prohibit rollovers to another state plan in accordance with the Internal Revenue Code.

3. ***Initial Deduction:*** NPERS did not have procedures to ensure initial contributions were not deducted in the same month the participant entered into an agreement in accordance with the Plan Document. Two of five documents tested were deducted in the same calendar month as the participant entered into an agreement with NPERS.

4. ***Expense Allocation Method:*** There was no verifiable evidence the allocation percentages used were consistent with the actual amount of time worked on each plan. The administrative fees collected by NPERS did not cover the expenses for every month. One of fourteen documents tested was not allocated in accordance with the expense allocation method.

5. ***Receipt of Non-Contributing Member Forms:*** NPERS did not have procedures to ensure Non-Contributing Member Forms were received timely.

More detailed information on the above items is provided hereafter. It should be noted this report is critical in nature since it contains only our comments and recommendations on the areas noted for improvement.

Draft copies of this report were furnished to NPERS to provide them an opportunity to review the report and to respond to the comments and recommendations included in this report. All formal responses received have been incorporated into this report. Responses have been objectively evaluated and recognized, as appropriate, in the report. Responses that indicate corrective action has been taken were not verified at this time but will be verified in the next audit.

We appreciate the cooperation and courtesy extended to our auditors during the course of the audit.

COMMENTS AND RECOMMENDATIONS

1. Monitoring Hartford Transactions

Members who had account balances with Hartford Life Insurance Company (Hartford) prior to September 1, 1997, had the option of maintaining the balances with Hartford or transferring the balances to Ameritas Life Insurance Company (Ameritas). Hartford remained the record-keeper for member account balances that were not transferred. Hartford performed transactions for benefit payments, transfers, and posting of earnings. Hartford prepared several reports to ensure requirements of the Internal Revenue Code (IRC) were met. One report included age-based information to ensure the participant received a minimum distribution according to the IRC. These reports were made available to the Plan Administrator upon request.

26 U.S.C. Section 401(a)(9)(c) (2000) requires participants to receive a minimum distribution payment no later than April 1 of the calendar year following the participant reaching age 70 and one-half, or retiring, whichever is later.

Hartford processed $5,530,729 in distributions to Plan members. Good internal control requires procedures to ensure transactions are processed according to Plan member instructions and to ensure accounts are properly monitored to ensure compliance with laws and regulations to prevent the loss or misuse of Plan funds.

NPERS did not properly monitor Hartford accounts to ensure:

- Participant distributions were actually processed and processed in the same manner the participant selected. A similar comment was noted in the prior audit related to transaction processing.
- Compliance with the IRC related to minimum distributions requirements.

Without proper procedures to review transactions processed by Hartford, there is an increased risk Plan members are not properly paid in compliance with the IRC.

We recommend NPERS:

- Implement procedures to ensure distribution requests forwarded to Hartford for payment are actually processed and processed in accordance with member instructions.
- Implement procedures to ensure compliance with the IRC related to minimum distribution requirements.

COMMENTS AND RECOMMENDATIONS

1. Monitoring Hartford Transactions (Concluded)

NPERS' Response: Hartford Life Insurance has been performing recordkeeping services for the Nebraska Deferred Compensation Plan (DCP) since 1979, and also provides retirement plan services to a large number of defined contribution plans nationwide. The company has been reviewed by Ernst and Young LLP, and a Statement on Auditing Standards 70 Service Organization report has been issued and forwarded to NPERS. This review included testing of the controls in place at Hartford for distribution processing. Distributions require written requests before processing, and are subjected to an independent review to make certain they are processed in accordance with the request. No exceptions were found at Hartford during this SAS 70 review, and NPERS has not experienced problems with distribution processing since our association with them. Therefore, NPERS feels adequate controls are in place at Hartford for proper processing of DCP distributions. We also know that members will notify our office if there are errors or omissions in their distributions, and that usually adjustments can be made.

NPERS does intend to increase the accounting related to the Hartford element of the DCP and make it comparable to the financial data maintained for the active account held at Ameritas. Therefore, we will be reviewing and posting totals for distributions as reports are received from Hartford. This will allow us to ensure that distributions and transfers from the Plan are monitored and properly authorized.

In response to your concern regarding risk of non-compliance with the IRC §401(a)(9) minimum distribution requirements, we must state that the risk is minimal, and not even relevant with regulations in effect for the plan year 2001. When benefits become payable under a §457 plan (upon separation from service), participants are permitted to make an irrevocable election to defer the receipt of the plan benefits until a fixed or determinable future date. Under §7(b) of our plan, it is outlined that a participant must make a distribution election within 90 days of separation from service. If a member fails to make a distribution election within that time frame, the plan will distribute benefits under an "automatic election" of equal payments over a specified period of time. Therefore, with the 90-day rule in effect in 2001, distribution decisions must be made well in advance of the age 70 ½ deadline, and no deferral date would be allowed beyond their 70 ½ birthday. Irrespective of the above, Hartford, as a retirement plan service provider, has automatic reports that are generated each January listing members that are age 70 ½ and follow-up letters are then sent to the members. This also provides our agency with the assurance that minimum distribution requirements are being met.

Auditors' Response: It is the responsibility of NPERS to have procedures in place to ensure the minimum distribution requirements of 26 U.S.C. Section 401(a)(9)(c) (2000) are met. The reports referred to by NPERS, which are generated by Hartford, had not been received or reviewed by NPERS at the time of our audit.

COMMENTS AND RECOMMENDATIONS

2. Transfer to Another State Plan

26 C.F.R. Section 1.457-2(a) (2001) states, an eligible State deferred compensation plan is a plan "satisfying the requirements of paragraphs (c) through (k) of this section." 26 C.F.R. Section 1.457-2(k)(1) (2001) states, the plan "may provide for the transfer of amounts deferred by a former participant to another eligible plan . . . if . . . the entities sponsoring the plans are located within the same state."

NPERS allowed a rollover to another state plan. One participant transferred his account balance of $14,189 to a deferred compensation plan sponsored by the State of Kansas. Noncompliance with the Code of Federal Regulations could disqualify the Nebraska Deferred Compensation Plan as an eligible plan.

> We recommend NPERS implement procedures to ensure the transfer of participant accounts to a Plan sponsored by another state are not allowed.

NPERS' Response: Deferred Compensation Plans may permit a participant to elect a direct transfer of amounts to or from another IRC §457 plan, but plan distributions prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were not treated as eligible rollover distributions. As stated in the audit comments, §457 regulations require that "plan to plan transfers" must be with entities sponsoring plans that are located within the same state. The transfer in 2001 from our DCP to a State of Kansas DCP was deemed to be a "plan-to-plan transfer", and therefore it was determined that the account balance should not have been transferred. The State of Kansas chooses to accept the funds as their rules allow these transfers if the member has terminated employment with the successor plan.

EGTRRA has greatly relaxed distribution rules for DCPs, and rollovers are now allowed to IRAs and qualified plans. Therefore, this is no longer an issue after the 2001 plan year.

3. Initial Deduction

26 C.F.R. Section 1.457-2(a) (2001) states an eligible State deferred compensation plan is a plan "satisfying the requirements of paragraphs (c) through (k) of this section." 26 U.S.C. Section 457(b)(4) (2000) and 26 C.F.R. 1.457-2(g) (2001) state that compensation is to be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the beginning of such month. Good internal control requires procedures to ensure the amounts are not deferred in the same calendar month as when the participant enters into an agreement with NPERS.

COMMENTS AND RECOMMENDATIONS

3. Initial Deduction (Concluded)

NPERS did not have procedures to ensure initial contributions were not deducted in the same month the participant entered into an agreement to defer compensation. Two of five initial contributions tested were deducted in the same calendar month the participant entered into an agreement with NPERS. Noncompliance with federal regulations could disqualify the Nebraska Deferred Compensation Plan as an eligible plan.

> We recommend NPERS implement procedures to ensure the initial contribution does not take place in the same calendar month the participant entered into an agreement to defer compensation with NPERS.

NPERS' Response: Our plan document for the DCP is in compliance with IRC §457(b)(4) in requiring that an agreement for deferral of a given month's compensation must be entered into before the first day of that month. In practice, agencies are actually beginning deferrals in the next pay period following receipt of the election form. This does not appear to present a compliance issue when employees are paid on a monthly basis, but employees paid on a bi-weekly basis could begin deferrals within the same month of receipt of their election. This was also a comment included in our Compliance Audit for 2001, but was not presented as a significant compliance issue.

In defining the DCP in the new payroll software under NIS, we are researching whether an entry date of "1st of the following month" can be written in the program to control this situation. We are also planning to add this condition to our Election Form to make certain members are aware of the requirement.

Auditors' Response: Although the Deferred Compensation Plan document is in compliance with 26 U.S.C. Section 457(b)(4) (2000), there were two of five contributions that were deferred in the same month in which the participant entered an agreement with NPERS. NPERS is not in compliance with the Code when initial contributions take place in the same calendar month the participant entered into an agreement to defer compensation with NPERS.

4. Expense Allocation Method

Neb. Rev. Stat. Section 84-1503(1)(c) R.S. Supp., 2001 required NPERS "to provide for an equitable allocation of expenses among the retirement systems administered by the board . . ."

Sound accounting practice requires an equitable method to allocate expenses of NPERS to each of the retirement plans and for the allocation to be applied consistently. The administration fees collected should be adequate to support all expenses incurred by the Plan.

COMMENTS AND RECOMMENDATIONS

4. Expense Allocation Method (Continued)

NPERS changed its allocation method effective July 1, 2001. The new allocation method was based on NPERS employees' estimates of time spent on each retirement plan. These estimates were reviewed and approved by each employee's manager. The percentages were reviewed quarterly and adjusted, if needed. There was no comparison of actual time worked on each plan to the estimate. Therefore, no verifiable evidence existed to indicate the estimates used were consistent with the actual amount of time worked on each plan.

We also noted the following related to the expense allocation method used by NPERS:

- The administration fees collected by NPERS were not adequate to cover the total expenses incurred to administer the Plan. Total administrative expenses for the year were $62,252 and the total fees collected for the year were $58,052. In each month during calendar year 2001, expenses charged to the Plan were higher than the reimbursements received from member fees.

- The allocation method was not applied consistently for the Deferred Compensation Plan. One of fourteen documents tested was not allocated according to NPERS' current allocation method. The expenses related to the Master Lease Agreement were allocated to the Plan at 1%. The overall allocation method was 2% to the Plan.

Without verifiable evidence that the estimated time worked on each plan is consistent with the actual time worked on each plan, there is an increased risk the Plan is not charged an equitable share of expenses. Additionally, if fees charged to members do not cover the costs allocated to the Plan, another means of paying expenses would be necessary. Finally, if the allocation percentage is not applied consistently, there is an increased risk the Plan is not charged an equitable share of expenses.

In order to be in compliance with State statutes, we recommend NPERS:

- Compare the estimated time spent on each plan to actual time worked.
- Ensure the total administrative fees collected for the year adequately cover the total expenses incurred by NPERS for the year.
- Apply the allocation percentage consistently to all expenses incurred by NPERS.

NPERS' Response: Since this comment was also included in our State and County Plan Audit, we will include a similar response. Based on audit results from prior years which indicated that member fees were increasing disproportionately among plans, we felt a review of our current

COMMENTS AND RECOMMENDATIONS

4. <u>Expense Allocation Method</u> (Continued)
NPERS' Response (continued)

internal cost allocation process was required. We began by reviewing payroll since it represents almost 60% of NPERS' costs. There appeared to be volatility in the cost allocations at the employee level, and some were difficult to justify. Employees were asked to carefully track their work time per plan for one week in each quarter. If they worked exclusively on a project for only one plan, all of their time would be allocated to that plan, even though under normal situations they may spend time working on all plans. Accounting staff simply averaged these time tracking reports from that quarter with other quarters and prepared payroll allocations without further analysis as to whether amounts reported were truly representative. The time tracking method required a significant amount of time for both the employee and the accounting staff, and yet was producing extremely volatile and undependable results.

In response to the above concerns, new time allocation sheets were prepared for each employee. They were asked to estimate the percentage of time spent on work for each plan during the quarter, or, if appropriate, the year if that time frame is more representative. Most employees did not find it difficult arriving at this percentage breakdown as many of them work exclusively on one to three plans only. Managers were also asked to review and sign-off on all allocations prepared by their staff. Questionable areas were subjected to a more thorough review that included estimates of calls involved and paperwork processed. The overall result from these allocations was reviewed and justified by comparing it to membership numbers, and results appeared to be very reasonable. It was decided that most agency administrative expenses would be allocated based on these payroll percentages, as it seems logical that overhead costs should match the time being spent by employees working on the plans. The study has been a significant improvement over the previous process, and the resulting costs per plan have been justifiable, dependable and less volatile. NPERS feels the method is definitely more equitable than the previous process, and that the cost allocations are reliable. We feel our employees are capable of estimating time spent working on plans, and putting these estimates into percentages of their work time.

Cost allocations for the Master Lease payments are currently being re-evaluated, as the scope of the Technology Project continues to evolve. Initial allocations for the Master Lease were based on membership numbers, but we continue to question the amount of time that is being required in the Technology Project to develop processes that relate only to the DCP. The software requirements and time spent in programming appear to be minimal.

A final comment in this audit point relates to whether current fees collected by the plan can adequately cover expenses incurred by NPERS. During 2001, the audit determined expenses totaled $62,252, while fees collected from the plan were a total of $58,052. As was explained during the audit, a "prior period credit" for 2001 in the amount of $5,131 provided the additional funds required to cover plan costs for the year. The DCP has no funding or

COMMENTS AND RECOMMENDATIONS

4. **Expense Allocation Method** (Concluded)
NPERS' Response (concluded)

appropriations to pay plan expenses – administrative costs charged by Ameritas, the recordkeeper, as well as our agency costs must be absorbed by plan members. NPERS is very diligent in trying to control the costs that must be charged against member accounts, but the plan document states that funds "from the deferred compensation plan assets and income" will be used to pay administrative expenses.

Auditors' Response: When estimates are used to allocate expenses to the various Plans, we recommend a periodic comparison of the estimate to the actual time worked. This recommendation was made to NPERS in previous audit reports of other Plans it administers and resulted in the quarterly employee time tracking mentioned by NPERS. Without a periodic comparison, the risk that expenses are not allocated equitably between the Plans increases.

Additionally, the fees reimbursed each month were not adequate to cover expenses incurred by NPERS. It is likely there will not be a prior period adjustment every year.

5. **Receipt of Non-Contributing Member Forms**

The Deferred Compensation Plan Document 7(b) (2000) requires a signed agreement to include the option elected by the participant for distribution payments to be selected within ninety days after retirement or termination.

Good internal control requires the timely receipt of Non-Contributing Member (NCM) forms to obtain assurance of the participant's termination of employment. Upon receipt of the NCM form, a disbursement packet was sent to the member and the distribution process was activated by NPERS.

We noted one of fifteen participants' NCM forms tested was received in excess of three years following the participant's termination date. The same participant's payment option was also selected more then three years following the termination date.

The distribution process is delayed when a NCM form is not received and a disbursement packet is not sent timely. This increases the risk of noncompliance with the Deferred Compensation Plan Document requirement for participants to select the payment option for distribution within ninety days after retirement or termination date.

> We recommend NPERS implement procedures to ensure all Non-Contributing Member forms are received within ninety days after retirement or termination to ensure timely payment of benefits.

COMMENTS AND RECOMMENDATIONS

5. <u>Receipt of Non-Contributing Member Forms</u> (Concluded)

NPERS' Response: NPERS currently requires Non-Contributing Member Forms from state agencies, as well as school districts, in order to properly process distributions from any of our plans upon member termination. No payout occurs until NPERS receives proper notification of the termination, retirement or death from the employer. Since the DCP is a voluntary plan, members may cease contributions at any time, but that interruption is not an indication of termination as it would be in our other retirement plans. Non-Contributing Member Forms received for state employees are always verified against the DCP membership file to determine if the terminated member also had a DCP account. The one exception noted in the audit was an unusual situation in that the member's employment was with the State Department of Education, and yet he was a participant in the School Retirement Plan. The School Non-Contributing Member Form was not verified against the DCP file, as it is an unusual circumstance when a School Plan member is also eligible for the State DCP.

The new system we are designing as part of the Technology Project has the capability of capturing termination dates directly from employer payrolls through the automated employer reporting process. This change in functionality was discussed with the auditors, as we do not anticipate a problem in the future since the non-contributing member notification will be automated.

Overall NPERS' Response: Since this plan had not been audited since 1997, we are very pleased that no "material instances of noncompliance" or "material weaknesses in internal control" were disclosed during the audit. We intend to enhance our accounting for the Hartford segment, but the remaining concerns expressed in the audit comments have already been eliminated through changes in legislation or procedural modifications with the Technology Project.

We also must express our concern for the amount of time that was expended by your staff, and required by our staff, to complete this audit. The DCP has less than 3,000 members, and therefore we appreciate the fact that the plan is not audited on an annual basis. We hope that open communication will continue to help us resolve some of these fairly inconsequential findings.

Overall Auditors' Response: Our audits are conducted in accordance with generally accepted auditing standards and *Government Auditing Standards*. Audits include determining whether financial information is fairly presented in accordance with generally accepted accounting principles, whether the entity has adhered to compliance requirements, and whether the internal controls are suitably designed and implemented. We are aware of the time and effort expended by your staff in the completion of the audit, and appreciate your cooperation and assistance.

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NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying Statement of Plan Net Assets of the Nebraska Public Employees Retirement Systems (NPERS) - Deferred Compensation Plan as of December 31, 2001, and the related Statement of Changes in Plan Net Assets for the year then ended, as listed in the Table of Contents. These financial statements are the responsibility of NPERS' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan and are not intended to present fairly the financial position and results of operations of the Nebraska Public Employees Retirement Systems in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan, as of December 31, 2001, and the results of the Plan's operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 29, 2002, on our consideration of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was performed for the purpose of forming an opinion on the financial statements of the Nebraska Public Employees Retirement Systems – Deferred Compensation Plan taken as a whole. The accompanying supplementary schedule is presented for purposes of additional analysis and is not a required part of the financial statements of the Nebraska Public Employees Retirement Systems – Deferred Compensation Plan. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Pat Reding, CPA

July 29, 2002 Assistant Deputy Auditor

NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN
STATEMENT OF PLAN NET ASSETS
AS OF DECEMBER 31, 2001

ASSETS		
Deposits with State Treasurer	$	1,986
Interest Receivable		48,530
Investments, at fair value (Note 4)		106,167,782
Guaranteed Investment Contracts, at contract value (Note 4)		9,000,810
Invested Securities Lending Collateral (Note 4)		326,479
Total Assets		115,545,587
LIABILITIES		
Investment Fees Payable		6,726
Obligations Under Securities Lending (Note 4)		326,479
Total Liabilities		333,205
Net Assets held in trust for pension benefits	$	115,212,382

The accompanying notes are an integral part of the financial statements.

NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN
STATEMENT OF CHANGES IN PLAN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2001

Additions:	
Investment Income:	
Net Income (Loss) from Investing Activities	$ (9,519,312)
Securities Lending Income	6,215
Securities Lending Expense	(5,364)
Total Net Investment Income (Loss)	(9,518,461)
Contributions	6,346,837
Total Additions	(3,171,624)
Deductions:	
Benefits paid to participants	5,663,221
Administrative expenses	133,013
Total Deductions	5,796,234
Net Increase(Decrease)	(8,967,858)
Net Assets held in trust for pension benefits:	
Beginning of Year	124,180,240
End of Year	$ 115,212,382

The accompanying notes are an integral part of the financial statements.

NOTES TO FINANCIAL STATEMENTS
For the Calendar Year Ended December 31, 2001

1. Plan Description

The Deferred Compensation Supplemental Retirement Plan (the Plan) of the Nebraska Retirement System is allowed per Neb. Rev. Stat. Section 84-1504 and 84-1512. The following description is provided in the NPERS Deferred Compensation Plan Document, which is based upon 26 U.S.C Section 457 (2000). The financial statements reflect only the Deferred Compensation Plan and do not reflect all the activity of the Nebraska Public Employees' Retirement Systems.

The Plan is a voluntary defined contribution pension plan. The Plan was established in May 1975 in accordance with 26 U.S.C Section 457 (2000) under the administrative responsibility of the Nebraska Public Employees' Retirement Board. The plan, available to all State employees, School employees, and County employees whose employer does not offer a similar plan providing services to the State, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. The Plan is recorded as an expendable trust fund in the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, for the fiscal year ended June 30, 2001.

Per Neb. Rev. Stat. Section 84-1505(1) R.R.S. 1999, "All compensation deferred under the plan, all property and rights purchased with the deferred compensation, and all investment income attributable to the deferred compensation, property, or rights shall be held in trust for the exclusive benefit of participants and their beneficiaries by the State of Nebraska until such time as payments shall be paid under the terms of the deferred compensation plan."

A. Contributions

Participants of the Plan may contribute an amount not less than $25 per month and not in excess of the lesser of $8,500 or 33 1/3% of includible compensation for the calendar year. Also, a participant may make a one-time election to defer an additional amount during one or more of the participant's last three taxable years immediately preceding a participant's normal retirement age. The total of this one-time election plus the normal contribution as described above cannot exceed $15,000 during any calendar year.

B. Participant's Account

Each participant's account is credited with the participant's contributions and an allocation of the investment earnings or losses. Allocations are based on participant account balances as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.

NOTES TO FINANCIAL STATEMENTS
(Continued)

1. Plan Description (Concluded)

C. Distributions to Participants

Distributions of benefits to participants can be made upon termination, retirement, death, or unforeseeable emergency. Distributions are in the form of a lump sum payment in cash equal to the value of the funds allocated to their account, an annuity option, a systematic withdrawal option, or a deferral option.

2. Summary of Accounting Policies

Basis of Presentation

The accompanying financial statements of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan have been prepared in conformance with generally accepted accounting principles (GAAP) as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

A. Basis of Accounting

The accounting records of the Deferred Compensation Plan are maintained and the financial statements were prepared on the modified accrual basis. Under the modified accrual basis of accounting, revenues are recognized when they are considered susceptible to accrual and expenditures are recognized when the liability is incurred.

3. Private Sector Administrative Agreements

Ameritas Life Insurance Company of Lincoln, Nebraska (Ameritas) is a private sector administrator of the Plan. Under the terms of the agreement and automatic extensions, Ameritas provided various accounting and reporting services and received compensation through maintenance fees charged against each participant account.

State Street Bank of Boston, Massachusetts is the custodian of the Deferred Compensation Plan's funds. The Nebraska Investment Council has also contracted with several investment managers, who manage each of Ameritas' funds. Each investment manager charges a unique management fee, which is deducted from the returns on the investment funds.

NOTES TO FINANCIAL STATEMENTS
(Continued)

3. Private Sector Administrative Agreements (Concluded)

Hartford Life was the private sector administrator of the Plan. Participants were able to maintain their accounts at Hartford Life or transfer the accounts to Ameritas' funds. No additional contributions are allowed in the Hartford funds.

4. Investments and Securities Lending

Investments, which are carried by outside investment firms, are carried at fair value based upon quoted market prices at December 31, 2001, or amortized cost when securities are not marked to market. Fixed interest rate accounts are carried at contract value as reported by the investment fund managers at December 31, 2001.

GASB Statement Number 3 requires government entities to categorize investments for the purpose of giving an indication of the level of risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered, or for which the securities are held by the System or its agent in the name of the System. Category 2 includes uninsured or unregistered investments for which the securities are held by the bank's trust department or agent in the name of the System. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer but not in the System's name.

Neb. Rev. Stat. Section 72-1243 R.R.S. 1996, authorizes the State Investment Officer to direct the investment and reinvestment of money in all State funds not currently needed and order the purchase, sale, or exchange of securities for such funds. The State Investment Officer participates in securities lending transactions, where securities are loaned to broker-dealers and banks with a simultaneous agreement to return the collateral for the same securities in the future. The NPERS custodial bank administers the securities lending program and receives cash, United States Government or government agency obligations, or convertible bonds at least equal in value to the market value of the loaned securities as collateral for securities of the type of loan at year end. Securities lent at year-end for cash collateral are presented as unclassified in the following schedule of custodial risk. Securities lent for securities collateral are classified according to the category for the collateral. At year end NPERS had no credit risk exposure to borrowers because the amounts NPERS owed the borrowers exceeded the amount the borrowers owed NPERS. There are no restrictions on the amount of securities that can be loaned, and there were no losses resulting from borrower default during the year.

4. <u>Investments and Securities Lending</u> (Continued)

Generally, either NPERS or the borrowers can terminate securities loans on demand. Cash collateral is invested in one of the lending agent's short-term investment pools that had average durations of 68 and 75 days. Because loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. There is no loss indemnification provided to NPERS by the contract with the custodian.

Short-term investments are invested in State Street Global Advisors Short Term Investment Fund, which is a money market fund. Mutual funds are not categorized securities and are not required to be categorized for GASB Statement Number 3.

The Nebraska Deferred Compensation Plan has several contracts with insurance companies pertaining to the Ameritas Funds. The accounts are credited with interest earnings and charges for Plan withdrawals and expenses as stated in the contract. The contracts are included in the financial statements at December 31, 2001 at contract value as reported to the Nebraska Investment Council by the investment fund manager. Contract value represents contributions made under the contract, plus earnings, less withdrawals, and expenses. The December 31, 2001, balance was $9,000,810 for the Deferred Compensation Plan. Activity is recorded in the Stable Fund. Guaranteed investment contracts are not required to be categorized per GASB 3.

The Ameritas funds including the S & P 500 Stock Index Fund, International Stock Fund, Money Market Fund, Bond Market Index Fund, Large Company Growth Stock Index Fund, Large Company Value Stock Index Fund, and Small Company Stock Fund are investments held in external pools. The International Stock Fund is registered with the U.S. Securities and Exchange Commission (SEC). The other external pools are bank-registered funds regulated by bank examiners. The fair value of their position in the pool is the same as the value of the pool shares. Investment funds for Hartford accounts consist of interest bearing deposits in Hartford's General Account plus a large number of retail mutual funds. The fair value of their position in the funds is the same as the value of the fund shares.

NOTES TO FINANCIAL STATEMENTS
(Continued)

4. Investments and Securities Lending (Concluded)

The following is a summary of the type of investments at carrying value at December 31, 2001:

Not Categorized

Investments held in external pools	$ 106,167,782
Guaranteed Investment Contracts	4,968,121
Synthetic Investment Contracts	3,711,900
Investments held by broker-dealers Under Securities Loan with Cash Collateral:	
Synthetic Investment Contracts	320,789
Securities Lending Short-Term Collateral Investment Pool	326,479
TOTAL	$ 115,495,071

Investments, at fair value	$ 106,167,782
Guaranteed Investment Contracts	9,000,810
Invested Securities Lending Collateral	326,479
Total Investments	$ 115,495,071

5. Contingencies and Commitments

Obligations Under Other Financing Arrangements. The State of Nebraska, through the Department of Administrative Services (DAS) – Accounting Division, has a Master Lease Agreement to be used by various agencies to purchase equipment. In December 2000, the Board first used this financing arrangement to finance the acquisition and installation of certain information technology equipment.

The first Master Lease Agreement was for $1,597,620 including interest costs of $262,620. A summary of the future minimum contractual obligations, for the first agreement, including interest at a rate of 5.239% as of December 31, 2001, is as follows:

Year	Principal	Interest	Total
2002	171,591	56,640	228,231
2003	180,800	47,431	228,231
2004	190,504	37,727	228,231
2005	200,728	27,503	228,231
2006	211,501	16,730	228,231
Thereafter	203,833	5,379	209,212

NOTES TO FINANCIAL STATEMENTS
(Continued)

5. Contingencies and Commitments (Concluded)

The second Master Lease Agreement was for $2,166,847 including interest costs of $241,847. A summary of future minimum contractual obligations for the second agreement, including interest at a rate of 3.245% as of December 31, 2001, is as follows:

Year	Principal	Interest	Total
2002	250,596	60,454	311,050
2003	259,239	51,811	311,050
2004	268,180	42,870	311,050
2005	277,429	33,621	311,050
2006	286,997	24,053	311,050
Thereafter	552,114	18,143	570,257

Litigation. The potential amount of liability involved in litigation pending against the Board, if any, could not be determined at this time. However, it is the Board's opinion that final settlement of those matters should not have an adverse effect on the Board's ability to administer current programs. Any judgment against the Board would have to be processed through the State Claims Board and be approved by the Legislature.

6. Subsequent Events

Master Lease Agreement

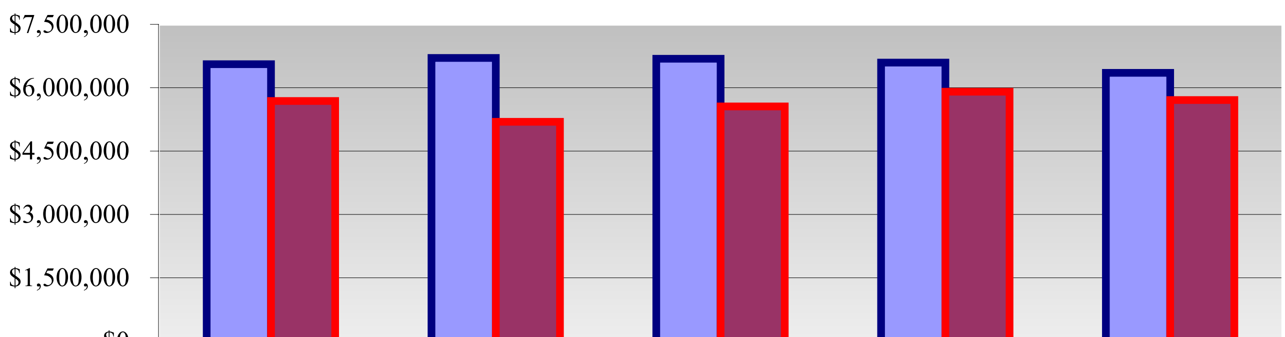
A third Master Lease Agreement was entered into by NPERS in July 2002. The total amount of $6,029,861 includes interest payments of $644,861. The interest rate is 3.129%.

NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN
SCHEDULE OF CONTRIBUTIONS AND DISTRIBUTIONS

	1997	(Unaudited) 1998	(Unaudited) 1999	(Unaudited) 2000	2001
CONTRIBUTIONS					
Ameritas Contributions	$ 2,239,315	$ 6,703,295	$ 6,606,464	$ 6,569,322	$ 6,353,091
Hartford Contributions	4,318,163	1,922	77,583	24,641	-
Total Contributions	$ 6,557,478	$ 6,705,217	$ 6,684,047	$ 6,593,963	$ 6,353,091
DISTRIBUTIONS					
Ameritas Distributions	$ 60,883	$ 1,217,818	$ 1,894,547	$ 2,047,437	$ 2,440,737
Hartford Distributions	5,622,861	3,975,551	3,660,861	3,858,158	3,268,119
Total Distributions	$ 5,683,744	$ 5,193,369	$ 5,555,408	$ 5,905,595	$ 5,708,856

Note: Participants were no longer allowed to contribute to Hartford after 1997. However, participants are allowed to transfer their Ameritas account balances to Hartford at the date of termination or at retirement. Participants in Hartford are allowed to maintain balances at Hartford or transfer their balances to Ameritas.
Note: The Distributions from Ameritas included transfers of participant account balances to Hartford funds for payout.
Note: The amounts used are cash basis figures.

CONTRIBUTIONS AND DISTRIBUTIONS



	1997	1998	1999	2000	2001
Contributions	$6,557,478	$6,705,216	$6,684,047	$6,593,963	$6,353,091
Distributions	$5,683,744	$5,193,369	$5,555,408	$5,905,596	$5,708,856

Contributions Distributions

STATE OF NEBRASKA
AUDITOR OF PUBLIC ACCOUNTS

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NEBRASKA PUBLIC EMPLOYEES RETIREMENT SYSTEMS
DEFERRED COMPENSATION PLAN

REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

We have audited the general purpose financial statements of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan as of and for the year ended December 31, 2001, and have issued our report thereon dated July 29, 2002. The report was modified to emphasize that the financial statements present only the funds of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan. We conducted our audit in accordance with 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.

Compliance

As part of obtaining reasonable assurance about whether the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan's general purpose financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. We noted certain immaterial instances of noncompliance that we have reported to management of the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan in the Comments Section of this report as Comment Number 1 (Monitoring Hartford Transactions), Comment Number 2 (Transfer to Another State Plan), Comment Number 3 (Initial Deduction), and Comment Number 5 (Receipt of Non-Contributing Member Forms).

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Nebraska Public Employees Retirement Systems - Deferred Compensation Plan's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to management of Nebraska Public Employees Retirement Systems - Deferred Compensation Plan in the Comments Section of this report as Comment Number 1 (Monitoring Hartford Transactions), Comment Number 3 (Initial Deduction), Comment Number 4 (Expense Allocation Method), and Comment Number 5 (Receipt of Non-Contributing Member Forms).

This report is intended solely for the information and use of the NPERS, the appropriate Federal and regulatory agencies, and citizens of the State of Nebraska, and is not intended to be and should not be used by anyone other than these specified parties.

Pat Reding, CPA

July 29, 2002 Assistant Deputy Auditor