

DEPARTMENT OF FIRE AND POLICE PENSIONS

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REPORT TO THE AUDIT COMMITTEE

July 7, 2011

ITEM: 1

FROM:  Michael A. Perez, General Manager

SUBJECT: **MEMBER BENEFIT PAYMENT PROCESS AUDIT AND POSSIBLE COMMITTEE ACTION**

RECOMMENDATION

That the Audit Committee review the Member Benefit Payment Process Audit and recommend it to the full Board for approval.

DISCUSSION

In accordance with the calendar year 2011 Annual Audit Plan and Forecast, Internal Audit Section (IAS) conducted the Member Benefit Payment Process Audit to evaluate LAFPP's processes and controls to ensure pension benefits are accurately communicated, calculated, and disbursed in accordance and consistent with the City Charter and Administrative Code. Providing these benefits to our members and assuring prompt delivery of benefits and services is our primary duty as a pension system and "shall take precedence over any other duty" (Article XVI, Section 17 of the California Constitution).

IAS concluded that communications, calculations, and disbursements of monthly pension benefits are in accordance and consistent with the City Charter and Administrative Code. With respect to the Deferred Retirement Option Plan (DROP) that provides a one-time benefit upon the member's exit from the program, IAS identified opportunities for improvement. Most significantly, the method by which interest is credited on DROP payments should be re-evaluated to ensure LAFPP credits interest only when pension obligations exist, and not before.

Briefly, for our sample of 11 DROP payments, a change in methodology would have resulted in an average loss of approximately \$1500 in benefits to the DROP participant. Currently there are over 1100 DROP participants that may be affected by a change. IAS consulted with the City Attorney regarding the matter, and the City Attorney concurs with the related recommendations.

IAS also made recommendations for efficiency improvements regarding systems used to manage and administer pension benefits, including automation of supervisory approval functions, and suggestions for the reconciliation process. Finally, IAS recommended development of policies and procedures as they relate to the member benefit payment process. The summary of recommendations is found on pages 12-13 of the audit.

BUDGET

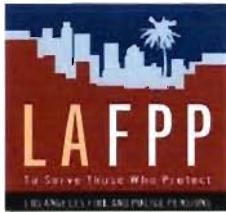
No impact at this time. However, if recommendations are implemented and changes are made to the methodology regarding crediting interest on DROP payments, there is potentially significant impact to the fund and to members who participate in DROP.



Erin J. Kenney
Departmental Audit Manager

MAP:EJK:CD

Attachment



MEMBER BENEFIT PAYMENT PROCESS AUDIT

(IAS No. 11-19)

June 2011

Internal Audit Section

Los Angeles Fire & Police Pensions Department

MEMBER BENEFIT PAYMENT PROCESS AUDIT
June 2011

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EXECUTIVE SUMMARY
Member Benefit Payment Process Audit
June 2011

PURPOSE

Pursuant to Internal Audit Section's (IAS) calendar year 2011 Annual Audit Plan and Forecast, IAS conducted the Member Benefit Payment Process Audit to evaluate the Los Angeles Fire and Police Pension's (LAFPP) process and controls for ensuring that pension benefits are accurately communicated, calculated, and disbursed in accordance with the City Charter and Administrative Code.

AUDIT OBJECTIVE AND METHODOLOGY

The overall objective of the audit was to evaluate whether LAFPP is accurately paying gross monthly pension amounts in accordance with the City Charter and Administrative Code and has adequate controls over communication regarding the pension process, calculations of benefits, and disbursements of pension payments. IAS evaluated this objective by conducting tests on materials and information that LAFPP makes available and distributes, and by reviewing a statistically valid and randomly selected sample of 105 pension payments made in December 2010. The sample was stratified by pension type and by tier.

AUDIT RESULTS

LAFPP is accurately communicating benefit information to its members. Materials available and information distributed are in accordance and consistent with the City Charter and Administrative Code.

LAFPP is accurately paying gross monthly pension amounts, and generally pension benefits are paid in accordance and consistent with the City Charter and Administrative Code. Pension payees met eligibility requirements, and gross monthly pension amounts were accurately calculated, including the cumulative application of annual cost of living adjustments. Control processes over the calculation and disbursement of pension payments were adequate; however, opportunities to improve control and efficiency exist as follows:

- LAFPP credits interest on Deferred Retirement Option Plan (DROP) payments the month before they become due. For example, LAFPP credits interest on January DROP pension payments, which are due January 31, *for the month of January*. This methodology is

Member Benefit Payment Process Audit Executive Summary

contrary to finance fundamentals and should be re-evaluated to ensure LAFPP pays interest only when pension obligations exist.

- There are inefficiencies, redundancies, and control weaknesses associated with LAFPP's use of three systems to manage and administer pension benefits. The role and functionality of each system should be assessed to streamline and better control the member benefit payment process.
- Although pension benefit calculations were manually approved by supervisors, supervisory approval should be automated and integrated into the system to better prevent unauthorized payments.
- The monthly pension roll reconciliation is not reconciled to the final disbursement roll, which undermines LAFPP's ability to detect errors, discrepancies, and irregularities creating potential opportunities for unauthorized payments.
- Written policies and procedures should be enhanced to better govern the member benefit payment process. The policies should be "top-down" with management-approved goals and objectives driving operational procedures.

MEMBER BENEFIT PAYMENT PROCESS AUDIT
June 2011

INTRODUCTION

Pursuant to Internal Audit Section's (IAS) calendar year 2011 Annual Audit Plan and Forecast, IAS conducted the Member Benefit Payment Process Audit to evaluate the Los Angeles Fire and Police Pension's (LAFPP) process and controls for ensuring that pension benefits are accurately communicated, calculated, and disbursed in accordance with the City Charter and Administrative Code.

This performance audit was conducted in accordance with Generally Accepted Government Auditing Standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Internal Audit Section has determined that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We especially want to thank the staff of Retirement Services Section, Accounting Section, Systems Section, and Communications and Special Projects Section for their assistance during the course of this audit.

Background

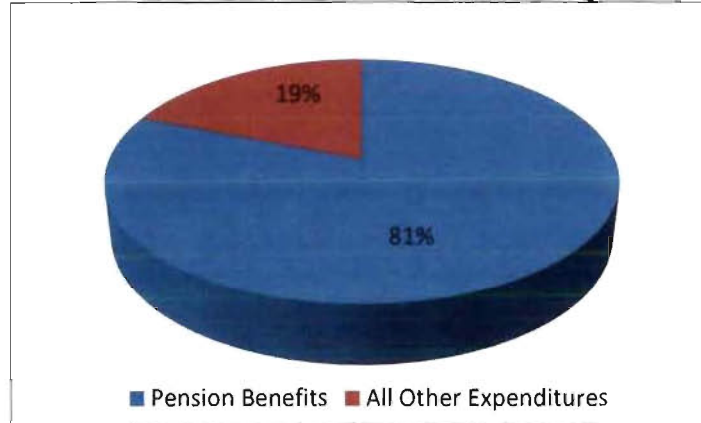
The LAFPP administers a five-tiered defined benefit pension plan with over 12,000 member retirees and beneficiaries. For fiscal year 2010-11, the total estimated pension expenditures are \$785,959,696 which comprises 81% of LAFPP's total expenditures of \$970,603,017 as reflected in Table 1 on the following page.¹

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¹ Estimated figures are pursuant to the approved Fiscal Year 2011/12 Budget.

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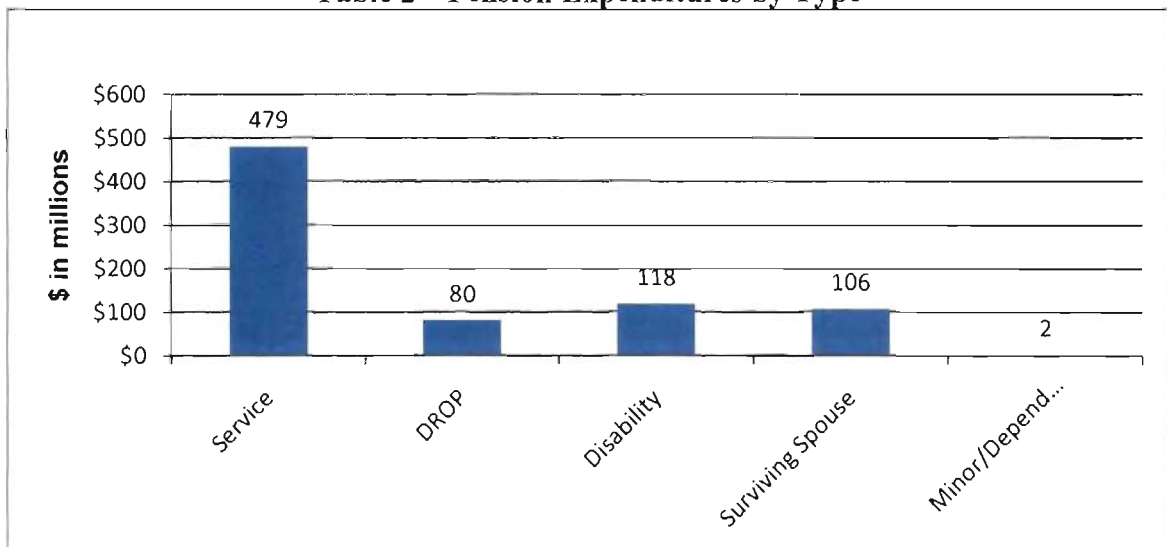
Table 1 – Fiscal Year 2010-11 Estimated Expenditures



Pension expenditures consist of the following pension types and are reflected in Table 2:

Service Pensions	\$479,213,064
Service Pensions – DROP ²	80,342,415
Disability Pensions	117,936,745
Surviving Spouse Pensions	106,277,305
Minor/Dependent Pensions	2,190,167
TOTAL	\$785,959,696

Table 2 – Pension Expenditures by Type



²DROP is an acronym for the voluntary Deferred Retirement Option Plan.

Audit Objectives, Scope, and Methodology

The overall objective of the audit was to evaluate whether LAFPP is accurately paying gross monthly pension amounts in accordance with the City Charter and Administrative Code and has adequate controls over communications regarding the pension process, calculations of benefits and disbursements of pension payments. Specifically, IAS evaluated the following objectives:

1. Pension benefits were accurately paid in accordance with the City Charter and Administrative Code:
 - a. Payees were eligible pension recipients;
 - b. Gross pension amounts were correctly calculated; and,
 - c. Cost of living adjustments were accurately made.
2. Pension benefit calculations were approved.
3. Adequate controls over monthly pension disbursement exist:
 - a. The monthly pension roll is reconciled and approved.
4. Benefit information was accurately communicated to members.
5. Policies and procedures were in place governing the member benefit payment process

IAS evaluated these objectives by conducting tests on materials available and information distributed to members, and by testing a randomly selected, statistically valid sample of 105 pension payments made in December 2010.³ The sample was stratified by pension type and by tier. See detail audit procedures in the Addendum section of this report.

Payments for medical and dental benefits were excluded from scope of this audit.

MANAGEMENT RESPONSE

On June 23, 2011, IAS met with management (executive management and section managers) and key operational staff regarding the audit findings and conclusions. On June 27, 2011, IAS redistributed a revised draft audit. On June 29, 2011, management expressed general agreement with the audit findings and conclusions.

³ In December 2010, there were over 13,000 payments totaling over sixty million dollars.

DETAILED FINDINGS AND RECOMMENDATIONS

Interest on DROP Benefits

Background

DROP is a voluntary program that allows participants to accrue an amount while remaining on active duty status receiving pay and benefits. This amount, as defined by Section 4.2102 (c)(1) and hereafter referred to as the “DROP payment,” is “equal to the monthly service pension to which the member would be entitled using the formula in the Tier in which the member is enrolled on the effective date of the member’s entry into DROP.” DROP payments are credited monthly to a DROP account.

In addition to the DROP payment, Section 4.2102 (c)(3) of the Administrative Code states that “a member’s DROP account shall be credited with interest in the amount of five percent (5%) annually. Interest will be credited to member DROP accounts semi-annually on the dates specified by the Board.” All amounts credited to the member’s DROP account are fully vested.

Findings

Contrary to the Administrative Code, the Board has not specified semi-annual dates on which interest shall be credited to member DROP accounts, and currently there is no Board policy regarding the issue. To facilitate the process, management has chosen to credit interest on DROP benefits monthly. However, this policy is also inconsistent with the Administrative Code and causes interest to vest earlier than the semi-annual frequency specified in the Administrative Code.

Furthermore, LAFPP’s interest calculation methodology accrues interest on DROP payments the month *before each* payment becomes due. That is, members start earning interest on the first day in DROP on their first DROP payment even though the payment does not become due until month end. Interest is computed similarly for each subsequent DROP payment while the member participates in DROP. This interest calculation methodology is contrary to finance fundamentals of paying interest on financial obligations or liabilities that are due.

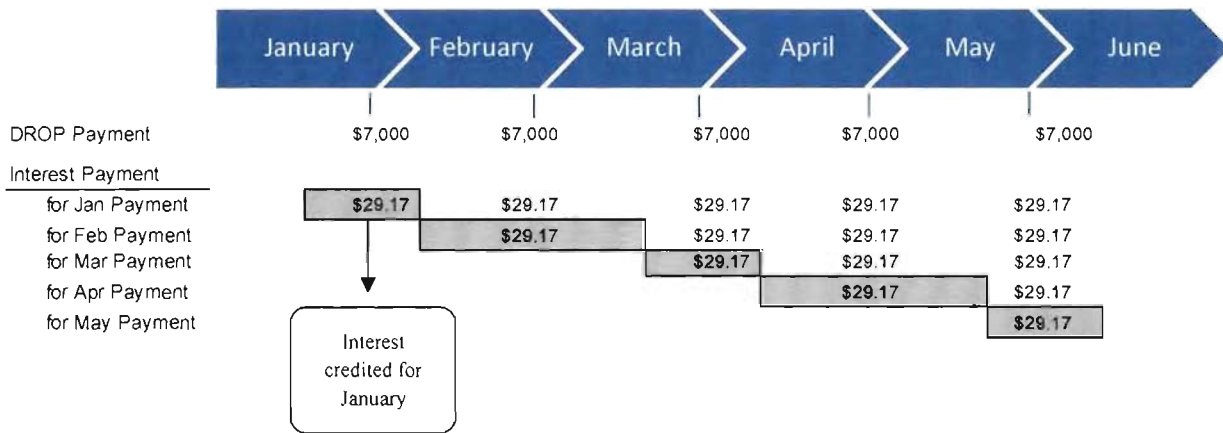
Pursuant to Sections 4.2102 (b) and (c)(1) of the Administrative Code, DROP payments are credited monthly (at month end) to the members’ DROP account at which time the credited amounts become fully vested. As DROP payments are neither due nor become vested to members until month end, LAFPP’s obligation for these payments also is not due until month end. Accordingly, LAFPP’s obligation to pay interest does not begin until after DROP payments have become due. The following scenario illustrates these points.

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SCENARIO:

A member retires January 1st with a \$7,000 monthly DROP payment.
Member earns \$29.17 per month per monthly payment as follows:

\$7,000
<u>5%</u>
\$350
<u>/12</u>
\$29.17



Note that the member is credited with \$29.17 in interest for the month of January despite the January DROP payment not being due until January 31. Also, note in the highlighted bordered areas that each subsequent monthly payment is similarly credited with interest for the months in which the payments are due. The un-highlighted areas represent interest appropriately credited after the DROP payments were credited and vested to the member’s account.

Without accounting for cost of living adjustments, the total interest in this scenario over 60 months computed using LAFPP’s current methodology would be \$1,840 higher than a methodology that does not pay interest on DROP payments before they become due as follows:

Methodology	Total 60 Months Interest
LAFPP	\$56,630
Alternate	\$54,790
Difference	\$ 1,840

There were 11 members in IAS’ sample who exited DROP in December 2010. IAS recomputed the interest for these members accruing interest only after payments became due. The recalculated cumulative interest utilizing this methodology for these members was \$16,745 less than computed utilizing LAFPP’s methodology. As of May 31, 2011, there were 1,115 DROP

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participants. This number is expected to increase with the passage of the City Council Ordinance on June 14, 2011 to freeze health subsidies for members retiring or entering DROP on or after July 15, 2011.

Recommendations

IAS recommends that:

- 1) Through its policies, the Board designate semi-annual dates on which interest shall be credited to member DROP accounts in accordance with Administrative Code Section 4.2102 (c)(3).
- 2) Management adopt DROP interest proration policies for participants exiting between the semi-annual dates.
- 3) Management re-assess the methodology used to compute interest on DROP benefits with consideration given to the financial impact to LAFPP of this methodology, and present its assessment to the Board.

System Efficiency and Control

Background

LAFPP utilizes two main systems to administer and pay member benefits: OnPoint and Benefit Payment Passport (BPP). OnPoint is LAFPP's primary member benefit management and administration system. It is a benefit calculator and member database maintaining critical member and beneficiary data such as personal information, payroll and contribution data, membership dates, tier, and payment history. BPP is a Northern Trust owned disbursement system utilized to calculate withholdings and disburse benefits to members based on monthly transaction data uploaded from OnPoint.

A third system, Microsoft Access, is utilized as report writer to summarize transactions for review and approval purposes. Microsoft Access is utilized to generate preview documents of pension payment additions, deletions, and change transactions uploaded from OnPoint.

The use of multiple systems for transaction processing is often necessary and, in many cases, effective. Multiple systems, however, can be inefficient, and in some instances, compromise the integrity of internal controls. These interconnected issues are discussed separately below.

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Microsoft Access

Utilized primarily as a report writer, Microsoft Access replicates existing transactional data from OnPoint and generates a transaction preview document of each transaction for review and reconciliation purposes. Retirement Service Section (RSS) supervisors review and approve hardcopies of the transaction preview documents and then forward them to Accounting Section. Accounting Section verifies and approves the payment amounts and then reconciles the approved transactions to the monthly pension roll. The transaction preview documents are then returned to RSS.

The use of Microsoft Access for supervisory approvals is a weak internal control. Transmissions from OnPoint to BPP are electronic. Transactions in OnPoint are available for transmission to BPP upon submission *irrespective* of the supervisor's written approval on hardcopy documents. These supervisory approvals are detached from the electronic transaction process flow, and do not prevent unauthorized payment additions, deletions, and other changes.⁴

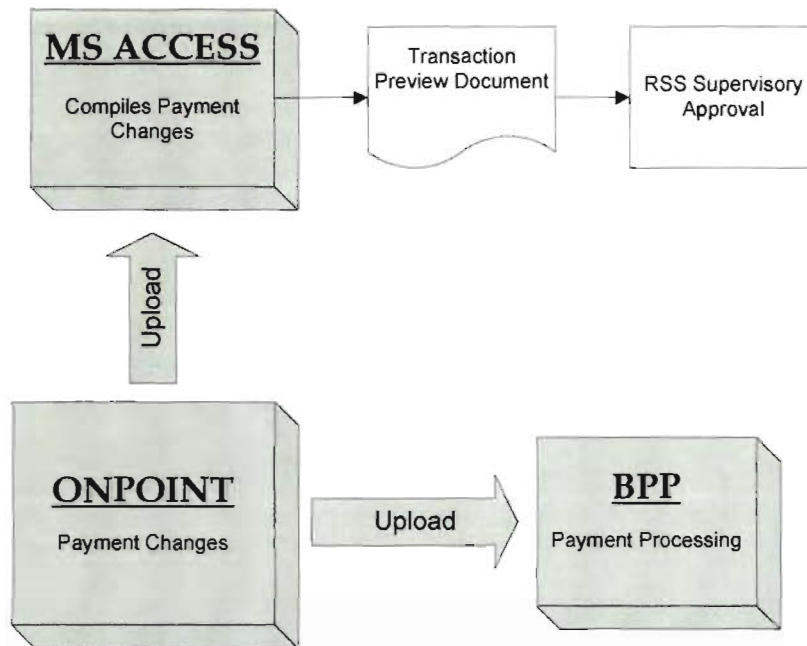
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⁴ Our testing did not identify any instances of unauthorized payments.

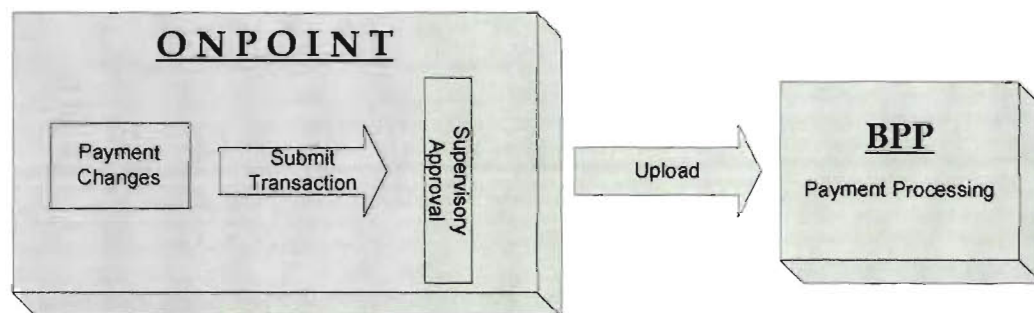
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The following illustration indicates the current un-integrated supervisory approval process as compared to an integrated supervisory approval process.

Unintegrated Supervisory Approval



Integrated Supervisory Approval



Additionally, the use of Microsoft Access is inefficient on several levels:

- The replication of existing data from OnPoint is redundant and requires Information System resources for application maintenance and support.
- The use of Microsoft Access necessitates manual reconciliations of the monthly pension roll.

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- Hardcopy documentation runs counter to the current paperless trend and results in missed cost savings for reduced printing and intra-office distribution needs.

Recommendations

IAS recommends that:

- 4) Management evaluate the use of OnPoint for an electronic supervisory approval process that produces summary reports of approved payments, additions, deletions, and changes for management review and to facilitate accounting reconciliations.
- 5) Management evaluate the use of Microsoft Access in the pension payment process with specific consideration to minimizing data redundancy and increasing efficiency.

OnPoint and BPP

As indicated above, OnPoint is LAFPP's primary benefit management and administration system utilized and supported by LAFPP to calculate benefits and maintain vital member information. BPP is a support system utilized to calculate withholdings and disburse benefits.

Certain member election and deduction data, such as voluntary deductions and tax withholdings, are directly entered and stored in BPP. This OnPoint/BPP setup was a vetted management decision to facilitate implementation of BPP but presents efficiency and control issues for a more mature system. This system setup of inputting such member data directly into BPP inefficiently bifurcates and backloads work because this data may be entered into BPP only after the member record has been loaded into BPP. Uploads to BPP typically occur mid-month during the monthly pension payment cycle, which can backload work up to two weeks. For example, if a new pension payment is processed in OnPoint at the beginning of the month, election and deduction data necessary to complete processing the payment cannot be entered until mid-month.

Additionally, this system setup lengthens the BPP payment cycle and the OnPoint "black out" period which further exacerbates the backload issue. The BPP payment cycle, which is approximately 12 business days, begins with the transmission of data to BPP and ends when pension payments are disbursed at month end. During the BPP cycle, OnPoint is unavailable for data entry, or "blacked out," for approximately seven business days primarily to allow data entry into BPP. Front-loading work in OnPoint would allow LAFPP to transmit transactions to BPP closer to the Live Run date thereby reducing the overall BPP cycle time and black out period.⁵

⁵ The Live Run is BPP's finalization of the monthly pension roll.

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Furthermore, a shorter BPP cycle would enhance the control effectiveness of monthly pension roll reconciliations discussed in the next section. See typical monthly pension roll cycle in Table 3 below.

Table 3 – Monthly Pension Roll Cycle

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
1	2	3	4	5	6	7
8	9	10	11	12	13 Transmission File Sent To BPP	14
15	16	17	18 Accounting Reconciliation	19	20 Live Run	21
22	23	24	25	26	27 Daily Activity Run	28
29	30 Payable Date					

OnPoint Pension Processing
BPP Payment Processing Cycle
Onpoint Black out Period

Recommendations

IAS recommends that management:

- 6) Evaluate the feasibility of utilizing OnPoint to centrally store and process member election and deduction data with consideration to operational efficiency, control, and costs.
- 7) Consider successor systems to OnPoint that integrate pension benefit administration and payment functions.

Pension Roll Reconciliation

Background

The Accounting Section is responsible for reconciling the monthly pension roll. Accounting calculates the total monthly pension roll by adjusting the prior month's final roll for approved payment changes received from RSS. The calculated pension roll is then reconciled to the roll to be disbursed in BPP. The monthly reconciliation serves to:

- Identify inconsistencies between the calculated roll and the roll to be disbursed by BPP;
- Approve the pension roll; and,
- Determine the funding amount.

Finding

The calculated roll is not reconciled to the final roll to be disbursed by BPP. The reconciliation is performed two and seven business days prior to the Live Run and Daily Activity Run, respectively. The Live and Daily Activity Runs are BPP's finalization of the rolls for monthly and one-time/partial pension payments, respectively. See monthly pension roll cycle in Table 3 above. As payment changes continue to be made after the reconciliation up until the Live and Daily Activity Runs, the underlying purpose of the reconciliation to detect errors, discrepancies, and irregularities is undermined creating potential opportunities for unauthorized payments.

Recommendation

- 8) IAS recommends that Accounting Section consider performing separate reconciliations for the Live and Daily Activity Runs closer to the respective run dates. Monthly BPP generated reports of payment changes entered directly into BPP may be used to facilitate the reconciliations.

Policies and Procedures

Retirement Services Section (RSS) and Communication and Special Projects Section (CSP) did not have adequate written policies and procedures to help ensure LAFPP's objectives are achieved. RSS had detail desktop procedures that required updating while CSP did not have any written policies or procedures.

Policies and procedures should define each section's objectives, responsibilities, processes and are essential components of internal controls. They align and integrate each section's objectives

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with those of the organization. For example, LAFPP's 2011-2012 Strategic Plan defines one of LAFPP's goals as customer service as related to the retiree payroll conversion project. While RSS and CSP have very different roles in this project, their objectives within their sections should be aligned in consideration of the other to promote the overall mission and goals of the organization. Finally, policies and procedures are effective in communicating objectives, expectations, and processes within the organization.

Recommendations

IAS recommends:

- 9) Retirement Services Section develop "top-down" objective-driven policies and procedures to govern the responsibilities of the section. The policies and procedures should be approved by management.
- 10) Communications and Special Projects Section develop "top-down" objective-driven policies and procedures to govern the responsibilities of the section. The policies and procedures should be approved by management.

SUMMARY OF RECOMMENDATIONS

IAS will follow up and report to the Audit Committee and to the Board regarding management actions taken regarding each recommendation indicated below.

IAS recommends the following:

1. Through its policies, the Board designate semi-annual dates on which interest shall be credited to member DROP accounts in accordance with Administrative Code Section 4.2102 (c)(3).
2. Management adopt DROP interest proration policies for participants exiting between the semi-annual dates.
3. Management re-assess the methodology used to compute interest on DROP benefits with consideration given to the financial impact to LAFPP of this methodology, and present its assessment to the Board.

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4. Management evaluate the use of OnPoint for an electronic supervisory approval process that produces summary reports of approved payments, additions, deletions, and changes for management review and to facilitate accounting reconciliations.
5. Management evaluate the use of Microsoft Access in the pension payment process with specific consideration to minimizing data redundancy and increasing efficiency.
6. Management evaluate the feasibility of utilizing OnPoint to centrally store and process member election and deduction data with consideration to operational efficiency, control, and costs.
7. Management consider successor systems to OnPoint that integrate pension benefit administration and payment functions.
8. Accounting Section consider performing separate reconciliations for the Live and Daily Activity Runs closer to the respective run dates. Monthly BPP generated reports of payment changes entered directly into BPP may be used to facilitate the reconciliations.
9. Retirement Services Section develop “top-down” objective driven policies and procedures to govern the responsibilities of the section. The policies and procedures should be approved by management.
10. Communications and Special Projects Section develop “top-down” objective driven policies and procedures to govern the responsibilities of the section. The policies and procedures should be approved by management.

ADDENDUM

Detail Audit Procedures

Pension benefits were accurately paid and approved (Objectives No. 1 & 2)

For Sample Payment Selections:

- Determined whether recipient met eligibility requirements
- Verified member's tier
- Verified membership date
- Verified retirement date
- Recalculated the members years of service
- Verified the member's lost service time (LST)
- Verified member's LST buyback, if any
- Recalculated the service year credit
- Verified the salary base utilized in the calculation was in accordance Charter and Code requirements
- Verified the designated final average salary (FAS) period (Tiers 3-5 only)
- Verified the salary base to PaySR
- Recalculated the FAS (Tiers 3-5 only)
- Recalculated the pension benefit percentage (Service only)
- Verified the pension benefit percentage is in accordance with Charter and Code requirements
- Recalculated the monthly benefit amount
- Reviewed for supervisor approval on the Service Retirement Calculation Worksheet
- Reviewed for General Manager approval
- Verified the monthly benefit amount to the award letter

Adequate controls over monthly disbursement exist (Objective No. 3)

For the December 2010 pension payroll reconciliation:

- a. Verified the beginning balance and prior month normalizing adjustments
- b. Agreed current month adjustments for periodic, lump, and "retro" payments to the supporting summary schedules and approved transmittal reports
- c. Agreed all BPP payment amounts on the reconciliation to supporting BPP queries
- d. Foot/cross-foot the reconciliation schedule to ensure the forecasted pension roll mathematically reconciled to the calculated BPP roll
- e. Reviewed for Chief Departmental Accountant and Assistant General Manager approvals
- f. Agreed total pension roll fund transfer amount to the bank statement

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Benefit information was accurately communicated (Objective No. 4)

Verified benefit information contained in the Summary Plan Descriptions, newsletters, annual report, and Survivor Benefit Handbook to the authoritative City Charter and Administrative Code

Policies and procedures were in place (Objective No. 5)

Reviewed the adequacy of policies and procedures for Retirement Services, Accounting, and Communication & Special Projects Sections