



Federated City Employees' Retirement System

Police and Fire Department Retirement Plan

Benefits Disbursement Process

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Executive Summary

As part of the FY2019-2020 audit plan, the benefits disbursement process has been audited with the primary objective of evaluating the internal controls on the initiation, processing, and recording of benefit payments. The overall process if lacking on controls, can lead to substantial financial risk to ORS. Examples may include the following: incorrect benefit payment amounts, theft, financial losses, increase in lost and returned checks and inaccurate financial reporting.

The audit covered the period from February 2019, the first month of implementation of the new version of the pension administration system, to September 2019. Scope includes the benefit disbursement process design, documented policies and procedures, and 100% of the benefit payments within the covered period.

In carrying out the audit, we discussed the overall disbursement process with staff and reviewed the documented policies and procedures. Controls all throughout the process were assessed through observation, inquiry of personnel, inspection of documents, and reperformance of certain controls. Analysis of the monthly benefit transactions was also performed.

Overall, controls for the benefit disbursement process from initiation, processing, and recording steps are strong. ORS observes good practices in administering benefit payments to members and beneficiaries. Control strengths identified are listed below.

- System access privileges are limited to users of the pension administration system. Accounting group does not have the authority to change payroll amounts while Benefits group cannot print checks from the system.
- Appropriate segregation of duties is present in each stage of the process.
- Reconciliation procedures are being performed to ensure validity of payroll changes and accuracy of benefit amounts paid and recorded.
- Transactions are supported by proper and adequate documentation.
- There is a thorough level of review. Each procedural step along the process requires at least one reviewer and approver.
- Timeliness is a key control emphasized all throughout the process.
- For asset security purposes, printed checks and payment advices for direct deposits are locked in a file cabinet until they are ready to be mailed.
- Outstanding checks are monitored to serve as an aid in the bank reconciliation process.
- ORS follows a sound process in keeping member address and bank information up to date.

However, the following are the issues identified that should be addressed to further strengthen the controls and improve the process over the benefit disbursement process.

- a. There was an issue noted regarding a check sequence number duplication. It was observed that there were some checks with the same sequence number but with different amounts and paid for a different purpose.
- b. Bank reconciliations for some months are not performed in a timely manner.
- c. The process of reconciling the total number and value of checks transactions to pension administration reports are not documented.
- d. The benefit payment internal control memo is not updated with the procedural changes and information due to the implementation of an upgraded version of the pension administration system.
- e. In inspecting the payroll journal entries for the monthly benefit payments, there are a few differences noted from the original general ledger transaction report generated from the pension administration system to the actual journal entries posted in FMS.

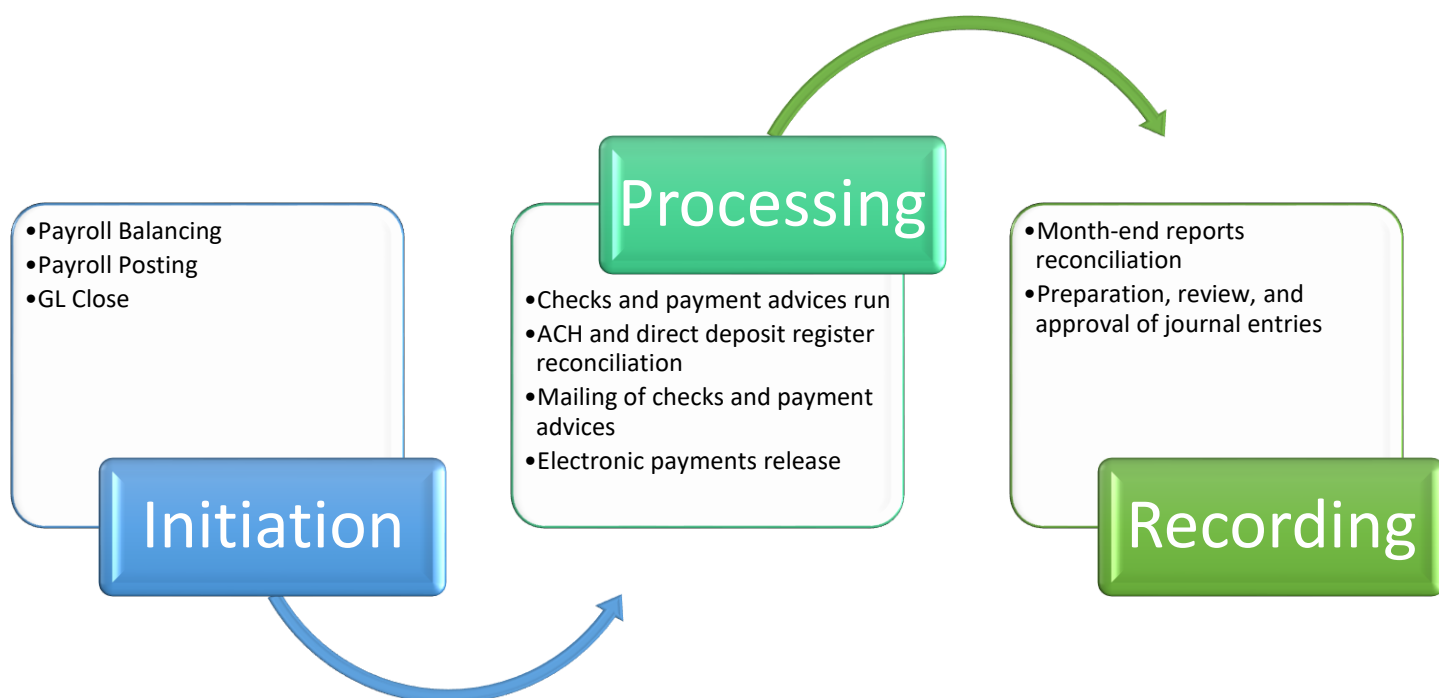
Audit recommendations based on the findings have been made in order to improve internal controls. Details of the findings and recommendations are addressed in the Audit Results section of this report.

Background

The City of San Jose – Office of Retirement Services (“ORS”) administers the two defined benefit plans namely the Federated Employees’ Retirement System (“Federated”) and Police and Fire Department Retirement Plan (“Police and Fire”). The department provides oversight for all employees that are eligible to receive retirement benefits.

ORS performs several services for the interest of the plan members but the ultimate goal is to provide the monthly payout to all benefit recipients. The disbursement procedures are essential in this function as inadequate and substandard process can expose the plans to financial risks.

Below is the disbursement process from initiation, processing, and recording of the transactions.



Initiation

Before proceeding with the processing of checks and payment advices, payroll balancing should be completed first. Payroll balancing is a process where benefit changes, additions, terminations, and insurance corrections are reconciled with the supporting documentation. Once done and reviewed, payroll will be posted in the pension administration system. General ledger will also be closed simultaneously so only the payroll for the month will be captured and processed in the system.

Processing

Benefit payments can be disbursed in two ways – check and direct deposit.

Checks are printed as soon as payroll is posted. After the checks and corresponding reports in the pension administration system are printed, the number of checks printed will be counted and reconciled to the report generated to ensure the total number of disbursements matches.

For direct deposits, a deposit register report and ACH file will be generated from the system. The two reports will be reconciled to make sure the total payment amount and the number of transactions agree. If there are discrepancies, a research will be conducted for resolution. Once all amounts are verified and reviewed, the ACH file will be sent to the bank for release. The bank will send a confirmation by fax to ORS and by email to Accounting Division once the file is received showing the number of employees. Accounting Division will also notify the administrative officer of the City's Treasury Division of the amount to be charged and of the number of transactions via email.

For recipients utilizing direct deposit and like to have a receipt, payment advices are also printed out. Together, the checks and payment advices are locked in a file cabinet until they are mailed on the last business day of each month. For electronic transfers, the bank will also send the payments on the last business day of each month.

Recording

After processing the checks and direct deposits, a journal entry will be prepared and reviewed. The journal entry will be entered into FMS which is the accounting system of the City. Hard copies of the signed journal entries and appropriate documentation are forwarded to Finance for processing and final approval.

Audit Objectives

The objective is to evaluate controls in the benefit disbursements process and determine whether monthly benefit payment transactions are authorized, approved, documented, and processed properly.

Audit Scope

The audit was performed for the period from February 2019, when the version 3 of the pension administration system was implemented, to September 2019. Sampled 100% of transactions within the covered period.

The audit specifically covers the following:

- a. Benefits disbursement process design
- b. Documented policies and procedures
- c. Monthly benefit payouts for the covered period

Audit Methodology

To perform the audit, the following procedures were performed:

General Procedures

- 1. Discussion with Accounting Division staff about the benefits disbursements process.
- 2. Review of documented policies and procedures.
- 3. Assessment of controls from initiation, processing, and recording process.
- 4. Analysis of benefit payment transactions.

Specific Procedures

A. Initiation

1. Reviewed payroll reconciliation to ensure changes are supported and validated.
2. Confirmed if payroll balancing, payroll posting, and general ledger closing are completed before running checks and payment advices.
3. Verified proper review and approval of the aforementioned processes.

B. Processing

1. Reviewed user access privileges and limits on the pension administration system.
2. Observed staff in printing checks and payment advices.
3. Reviewed reconciliation in ensuring checks and ACH file match corresponding reports from the pension administration system.
4. Checked reason and resolution for discrepancies between pension administration reports.
5. Determined if there are procedures in place to keep bank information and addresses updated.
6. Gathered notifications from the bank confirming the total number and amount of ACH transfers.
7. Verified if processing of direct deposits were done on the last business day of each month.
8. Observed proper review and approval of the aforementioned processes.

C. Recording

1. Checked if benefit payments were recorded timely and accurately in the correct period.
2. Observed proper review and approval of journal entries.
3. Verified appropriate and complete documentation.
4. Checked if the recorded benefit payments match the related reports from the pension administration system.
5. Traced the cleared checks and monthly direct deposit amounts to the bank statements.
6. Verified if adjustments were recorded properly for voided and/or reissued checks and deleted deposits.
7. Reviewed the monthly ZBA bank to book reconciliation.

Audit Results

Based on the audit procedures performed, it was concluded that controls for the benefit disbursement process from initiation, processing, and recording steps are strong. Overall, ORS observes good practices in administering benefit payments to members and other benefit recipients.

Control Strengths Identified

Control Item	Initiation	Processing	Recording
Authorization and Segregation of Duties	<ul style="list-style-type: none"> - Any adjustment related to benefit changes, additions, terminations, and insurance corrections are managed by the Benefits Division. Accounting group does not have the ability to change payroll amounts in the pension administration system. - Staff performing the payroll balancing and posting is different from the person closing the general ledger in the pension administration system. 	<ul style="list-style-type: none"> - Only authorized persons can access the check printing software in the pension administration system. - The staff responsible for printing the benefit checks is not involved in any other functions of the disbursement process. - The staff reconciling the total number and amount of direct deposits is separate from the person electronically uploading the ACH file to the bank's portal. - Mailing of checks and payment advices are done through the City's mailing function. 	<ul style="list-style-type: none"> - The City's finance department has the authority to do final approval of the journal entry.
Reconciliation	<ul style="list-style-type: none"> - Staff performs comprehensive reconciliation of monthly benefit changes. Reconciliations are mathematically accurate and the differences match the supporting documents. 	<ul style="list-style-type: none"> - Total number of checks and direct deposits are reconciled to the pension administration reports. - Variances noted in the direct deposit payments reconciliation are resolved. Reason for such discrepancies are validated and supported with proper documentation. 	<ul style="list-style-type: none"> - The preparation of journal entry involves thorough reconciliation of the benefit disbursement amount with detailed breakdown. - Each amount in the journal entry is reconciled to supporting documents gathered in the initiation and processing functions.

Control Item	Initiation	Processing	Recording
Reconciliation (continuation)			<ul style="list-style-type: none"> - The VIS codes are also checked to ensure correct account codes are used since there are some discrepancies between the pension administration system and FMS. - Total disbursement amount ties to the benefit payroll register report with no exceptions noted. - Recorded payroll figures matched the numbers in the bank statements. - Bank reconciliations are prepared by a staff independent of the benefit disbursement recordkeeping.
Documentation	<ul style="list-style-type: none"> - Benefit changes are validated with a variance memo or a payroll change form along with other supporting documents. - Payroll balancing report includes all records on benefit changes, additions, terminations, and insurance corrections. 	<ul style="list-style-type: none"> - Pertinent documentation such as ACH files, direct deposit register file, bank confirmation, discrepancy report, and other applicable information are stored and maintained properly. 	<ul style="list-style-type: none"> - Appropriate and complete documentation are attached alongside the signed journal entry forwarded to the City's finance department. Each line item in the journal entry is backed by relevant reports.

Control Item	Initiation	Processing	Recording
Review Process	<ul style="list-style-type: none"> - Variance memos and payroll change forms are reviewed and signed-off for accuracy and validity. - Before posting the payroll in the pension administration system, two levels of review are being performed to make sure payroll is balanced and all changes are supported. 	<ul style="list-style-type: none"> - Reconciliation of the total number and amount of benefit direct deposit payments between certain pension administration reports are reviewed before providing the final ACH file to the bank. 	<ul style="list-style-type: none"> - Journal entries are reviewed thoroughly for accuracy and proper documentation. Two staff are required to perform the review process before sending the signed hard copies to the City's finance department. - Additional layer of review is done by the City's finance department before subsequently approving the entry.
Timeliness	<ul style="list-style-type: none"> - Payroll balancing preparation and review are completed at least a week before the benefit payment date which is the last business day of each month. - Payroll posting and general ledger closing in the pension administration system are carried out as soon as payroll reconciliation is done. 	<ul style="list-style-type: none"> - Checks are printed and ACH files are created as soon as payroll is posted and general ledger is closed. - Reconciliation of checks and direct deposit amounts are also performed in a timely manner. - Direct deposit payments are processed on the last business day of each month with no exceptions. 	<ul style="list-style-type: none"> - Preparation, review, and approval of journal entries are done in a timely manner.

Other control strengths not categorized above are the following:

A. Asset Security

Printed checks and payment advices for direct deposits are locked in a file cabinet until they are ready to be mailed.

B. Voided and reissued checks

Payments that should be voided and reissued are processed with appropriate documentation and verification. Reversal and correcting journal entries are also prepared and reviewed in a timely manner.

This scenario is mostly due to lost checks. Members or beneficiaries receiving their monthly benefits through paper checks will contact ORS if they did not receive their checks. Staff will then confirm with the bank if they are still outstanding. Once verified, checks will be reissued and correcting journal entries will be consequently posted in the system.

C. Outstanding checks

Outstanding checks are monitored. This serves as an aid in the monthly ZBA bank reconciliation.

D. Member addresses and bank information

ORS has a good process of keeping member addresses and bank information updated. This is especially important to ensure payments are going to the correct recipients and to minimize the risk of lost checks. Although less than 2% (Fed: Average of 89 checks out of 4,613 transactions per month; PF: Average of 34 checks out of 2,527 transactions per month) of the benefit payouts are done through paper checks for both pension plans, financial risk is still present as monthly payments by way of checks average \$205,000 and \$162,000 for Federated and Police and Fire plans, respectively.

Change of address and direct deposit forms are readily available in the retirement website. Members can also confirm if they have the right address through the member direct portal. While the responsibility of updating address and bank information lies on the members, ORS does constant reminders through group counseling sessions, retirement planning workshops, open enrollment, and health fair events. There is also a designated individual handling return mails. He is responsible for contacting the member or beneficiary to verify the correct communication address and subsequently update it to the pension administration system.

Moreover, staff will soon provide newsletters and incorporate reminders about address and bank information. They are also considering putting notes on the checks and payment advices being mailed out to benefit recipients.

Below are the issues identified that should be addressed to further strengthen internal controls over the benefits disbursements process. Management was already made aware and a summary of their response on findings and recommendations will be documented separately.

Priority Rating Process

To assist management in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed as high, moderate, or low as follows:

1. High – Finding that requires immediate action by management.
2. Moderate – Finding that requires timely action by management.
3. Low – Finding that requires action by management at the earliest convenience.

Finding #1: While performing the procedure of tracing the cleared checks to the bank statements, there was an issue noted regarding a check sequence number duplication. It was observed that there were some checks with the same sequence number but with different amounts and paid for a different purpose.

The pension administration system has controls over check sequence numbering. It is supposed to pick up the last printed check number and start with the next numerical number which is usually the “highest plus one”. Users can create a gap by manually creating a new starting number as long as it is greater than the last printed check number. If a new starting number is manually assigned, an error will prompt if the check number has already been used. With these IT controls in place, there shouldn’t be any problem with check number duplication but for some unidentified reason, the issue still took place.

Upon talking to accounting staff, they were not aware of the issue until the bank sent notifications to raise the concern. This was then brought up to IT group and pension administration system’s vendor and the matter is currently being investigated. For the meantime, a manual monitoring process was implemented to make sure there will be no duplicate check numbers in the future. Staff is now checking the last printed check number from the benefit check register report and manually entering the next sequence number.

Priority Rating: Moderate

Recommendation #1: Follow up with IT group and system’s vendor to ensure controls that are supposed to be present are working as expected. This is to make certain that the check number duplication issue will not happen again.

Although, a manual monitoring process was implemented to fix the problem, there is still a possible risk due to human error. An automated control in place is better in this situation as we are dealing with considerably large volume of transactions that are similar in nature. If the IT controls are working as it should, there will be reduced risk that controls will be circumvented, segregation of duties will be enhanced, and information will be available in a timelier manner.

Pre-numbered checks with correct sequence is critical in the department’s system of internal controls over the disbursement process. Pre-numbered documents help ensure completeness of important documents. It also serves as an audit trail for department. If there are duplicates, it will be harder to investigate and resolve potential matters of error or fraud.

Finding #2: Bank reconciliations for some months are not performed in a timely manner.

Due to the annual statutory audit season, bank reconciliations for the interim audit period up to the completion of the comprehensive annual financial report (May 2019 to October 2019) have not been completed.

Priority Rating: Moderate

Recommendation #2: Timely reconcile the ZBA bank accounts to the general ledger on a monthly basis. Set-up a timeline to complete the reconciliation within 30 days after the month-end date. Preparer and reviewer should sign-off their initials along with the corresponding date.

Monthly bank reconciliation helps the department in identifying unusual transactions that might be caused by accounting errors or fraud. It can also benefit management in recognizing internal administrative issues such as cash flow management, recordkeeping policy, cash custody and availability, investment management and other accounting processes.

Proper and timely reconciliation is a fundamental control that can lead to a more efficient process of identifying issues and timelier resolution of potential accounting errors. Staff will be able to ensure all transactions are entered into the accounting system, catch any bank or book errors, adjust journal entries promptly, present accurate financial reports, avoid fees, and keep track of outstanding checks. For example, during the audit, there was one benefit recipient for the Federated plan that hasn't liquidated his checks since March 2019. The checks issued from March 2019 to September 2019 are still outstanding to date. If reconciliations were done in a timely manner, this pattern would have been observed and an appropriate individual can follow-up with the person to make sure he is receiving the checks and if any information should be updated such as address or to confirm if the person is still alive. An appropriate staff will then be able to take necessary steps to address the issue.

Finding #3: The process of reconciling the total number and value of checks transactions to pension administration reports are not documented. This is not to say that the preparation and review of the reconciliation process are not happening. There is just no formal indication that these procedures are being done.

After printing the checks, the system will automatically generate a positive pay file. This report is similar to an ACH file which includes individual check amounts as well as its summation. The staff responsible for reconciliation process will also download the benefit payroll check register report and will perform a three-way reconciliation between the actual checks, positive pay file, and check register report to count the number of checks and verify the total value of the transactions. This course of action is being followed but there's no evidence that the procedures are being carried out.

Priority Rating: Moderate

Recommendation #3: Check reconciliation procedures should be modified to show proof of preparation and review. Similar to the direct deposit transactions reconciliation, a sign-off should be required that specifies the preparer and reviewer's initials and the date the actions are performed.

Finding #4: The benefit payment internal control memo is not updated with the procedural changes and information due to the implementation of an upgraded version of the pension administration system.

With the transition from version 2 to version 3 of the pension administration system, some information are not applicable anymore. During the review of the internal control memo, a few of the relevant changes were noted below.

- a. The benefits change report used for payroll balancing procedures now includes a fourth section for insurance corrections. The previous version only contains three parts – benefit changes, benefit additions, and benefit terminations.
- b. For check processing, a separate locked computer is not used anymore for printing checks. Version 3 of the system directly allows authorized users to use their individual computers.
- c. To complete the check processing and make them negotiable, there used to be a signature plate for check signing purposes. After printing the checks, staff will use the machine to stamp the appropriate signatures. For the current version, the check-printing function of the system now permits printing of the required signatures.

Priority Rating: Low

Recommendation #4: Update the current internal control memo in place to revise applicable changes due to the conversion of the pension administration system to a newer version.

Keeping policies and procedures updated will ensure staff will have the right information in performing their duties and responsibilities. This will help increase operational efficiency and minimize possible errors while executing the designated tasks.

Finding #5: In inspecting the payroll journal entries for the monthly benefit payments, there were a few differences noted from the original general ledger transaction report generated from the pension administration system to the actual journal entries posted in FMS.

The differences noted are not truly inconsistencies nor actual variances. Staff is just revising the raw report to match the correct account codes that should be used in FMS. There's just an incompatibility issue between the codes used in the pension administration system and FMS. Furthermore, some line items in the original ledger transaction are in lumped amount. They need to be broken down into specific components and booked separately under the right classification.

Priority Rating: Low

Recommendation #5: Develop a comprehensive file that will show the items that should be noted in preparing the journal entries. Make a list of the account code differences between the two systems and create notes on the things that should be looked out for. This will serve as an overall guide in posting monthly payroll entries. The file will also help facilitate the review process. It will serve as a tool to verify validity of changes between the initial report and the posted version. Moreover, this will also be beneficial in case the staff preparing the journal entries isn't around. Anyone within the accounting group can pick up the responsibility and create the entries while preventing errors or inaccuracies.

In the long run, consider requesting the pension administration vendor to resolve the incompatibility issue with account codes so staff won't need to manually amend the initial report. This will be a better control in preventing mistakes due to human error or intervention.

Appendix A - Control Risk Reassessment

Control Risk Scoring Scale

1 Strong	2 Reasonably Strong	3 Adequate	4 Marginally Adequate	5 Weak or Nonexistent
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Initial Assessment – Control risk for benefit disbursement process was rated 3 in the planning phase of the audit based on the assumption that internal control design is present but there's not enough evidence to conclude its effectiveness and proper implementation.

Reassessment – After performing test of controls in the audit execution, it was determined that controls are reasonably strong. If recommendations will be implemented, internal controls will be categorized under strong (1) classification.

Division	Audit Activity	Control Risk Score (Initial Assessment)	Control Risk Score (Reassessment after Audit Testing)	Control Risk Score (If recommendations will be implemented)
Accounting	Benefits Disbursement Process	3	2	1