



Federated City Employees' Retirement System

Police and Fire Department Retirement Plan

Cash Disbursement Process

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Executive Summary

We audited the cash disbursement process with the purpose of evaluating the controls over cash payments other than monthly pension benefit expenditures. Transactions were analyzed to determine whether they are authorized, approved, documented, and processed properly and timely. This process is important in order to fulfill the department's duties by receiving continuous operational support from vendors.

In executing the audit, we reviewed the cash disbursement process design along with the documented policies and procedures. Cash transactions within the fiscal year 2018-2019 were examined. Controls were assessed from initiation, processing, and recording of payments.

Based on the audit procedures performed, it was determined that ORS has good practices in administering cash disbursements to vendors. Positive observations noted are as follows:

- Authorization and access to financial accounting system is limited to accounting personnel. Check printing function in the pension administration system is also restricted to certain users only.
- Proper segregation of duties is implemented all throughout the process.
- There is a thorough review and approval process in place.
- Appropriate and complete documentation are stored and maintained.
- Amounts paid are accurate. For pension related expenses, reconciliation is being performed to ensure month to month differences are valid. Material variances are analyzed and substantiated. For other operating and administrative expenses where invoices are received, amounts are compared to contracts and/or purchase orders to make sure they matched.
- Process of reimbursing payments made by the Finance Department on behalf of ORS is sound. Cash transferred based on estimates are reasonable.
- In general, timeliness is a fundamental control emphasized in preparation and review of journal entries, vendor reconciliation, reimbursement process including wiring of funds, and vendor payments.

However, few issues were identified that should be addressed to further strengthen internal controls over the cash disbursement process.

- a. From the samples selected for operating and administrative expenses, 13 out of 50 invoices were paid late (3 – 90 days late). Amounts vary from \$1,200 to \$42,000.
- b. Instruction to wire funds from ORS's cash custody bank (State Street) to the Finance Department's bank (Wells Fargo) for reimbursement purpose is done through a less secure channel which is by fax.
- c. There is no threshold set for the month to month vendor payroll variance analysis.

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 contracts several goods and services providers to support the operating and administrative functions of the department. Vendors range from health care facilities, investment and risk advisors, federal and state tax agencies, actuarial services, financial software, audit and law firms, pension administration services, credit union, professional and other membership associations, and office supplies.

As with the typical business relationships, in exchange for goods and services provided, vendors need to be compensated through cash payments. Cash disbursement process is an essential part in sustaining the department's operational functions and continue fulfilling its responsibilities to the members and beneficiaries of the pension plans. The process if followed without sufficient controls can lead to certain risks such as late processing, inaccurate amounts, payments to incorrect recipients, improper recording of journal entries, and erroneous financial reports.

For the purpose of this audit, only disbursements to the vendors are included. Pension benefit payments and investment fundings are excluded.

Cash disbursements are processed in two ways.

1. Payments through Pension Gold, the department's pension administration system

Retirees eligible for monthly benefit payments may designate a portion of their retirement benefits for purposes such as medical, dental, or vision insurance, child support, or retirees' membership association. Only payments that relate to pension benefits can be made via the pension administration system as the funds are deducted from the retirees' accounts.

Along with the monthly payroll benefits to plan members and beneficiaries, a designated individual will process the vendor payroll through the pension administration system. A vendor payment register will be extracted from the system and will be compared to other supporting documents. Most of the amounts can be cross-checked to the benefit payroll register report as these pertain to insurance deductions, federal and state withholding taxes, other pension deductions as well as health insurance subsidy. The remaining figures are related to taxes and insurance portions for return of contributions and other adjustments made within the month.

Staff also performs variance analysis to verify any material upward or downward changes. Vendor payments for the current month will be compared to prior month and any significant movement will be documented and matched with supporting information. Entry to the pension administration system will then be posted after the review and approval of reconciliation and payment details. Disbursements will be processed directly through Pension Gold by issuing checks or direct deposits (see Benefits Disbursement Process Audit Report for the detailed process) or manually by paying on the online website or creating an "Edit List" in the City's general ledger system, FMS which will then be processed by the City's Finance Department.

2. Payment directly through the City's Finance Department

For outlays not related to pension benefits such as operating and administrative expenses (e.g., investment, audit, legal, and pension administration services), Pension Gold is not involved in the process. These are the expenditures where the department typically receives invoices.

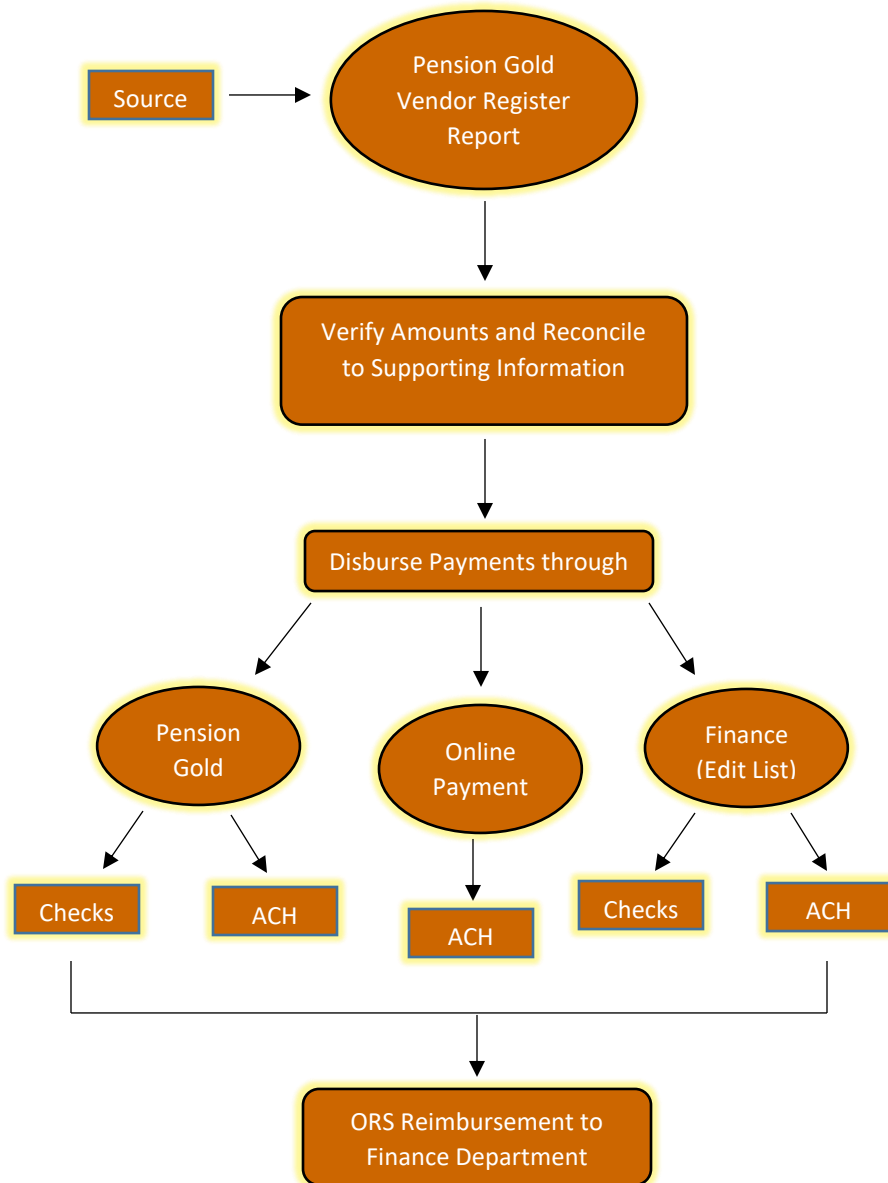
The process is as follows:

- a. Invoice is received.
- b. Accounting staff will determine if there is a signed contract. He or she will pull up the contract and verify the figures agreed upon or the basis of invoiced amount, if not fixed. Recalculation is done, if necessary.
- c. The invoice will be given to the staff managing the goods or services provided by the specific vendor. For example, if the invoice is related to investment advisory services, the accounting staff will forward it to the investment group. An individual from that group will review and initial the invoice.
- d. The initialed invoice will be given back to accounting group and will then be forwarded to the Department Director or Deputy Director for final review and approval.
- e. Accounting staff will initiate payment request in FMS by completing and Edit List in the system. An Edit List is called a cash journal voucher, journal voucher and invoice entry within FMS. All entries require an Edit list within FMS, including cash disbursement entries.
- f. The Edit List prepared for invoice payment will be printed and signed by the preparer.
- g. The Senior Accountant will perform the 1st review and the Accounting Division Manager will carry out the 2nd review. Both individuals will sign-off on the edit list with their initials and date the actions are executed.
- h. Completed hard copies of the edit list will be forwarded to finance for final approval of the payment along with the journal entries.
- i. Payments will be processed through checks or ACH depending on vendor preference. Edit lists that are received by the Finance Department by 5:00 pm on Thursday will be paid by the following Friday.

In both ways of disbursing cash, the department is using the funds in the bank account held by Finance Department. On a monthly basis, ORS reimburses the Finance Department for all monthly cash activity made on behalf of Retirements Services through all Edit lists processed. The monthly activity is listed on the general ledger detail report. The GL detail report is downloaded into a monthly Actual versus Estimate excel report. An analysis will be made and reimbursement will be transferred from the Retirement plans' custodian bank accounts to the Finance department's bank account. Total transfer amount includes the projected retirement benefit payments, current month general and administrative expenditures, and prior month's true up of expenses including adjustments for cash collections received.

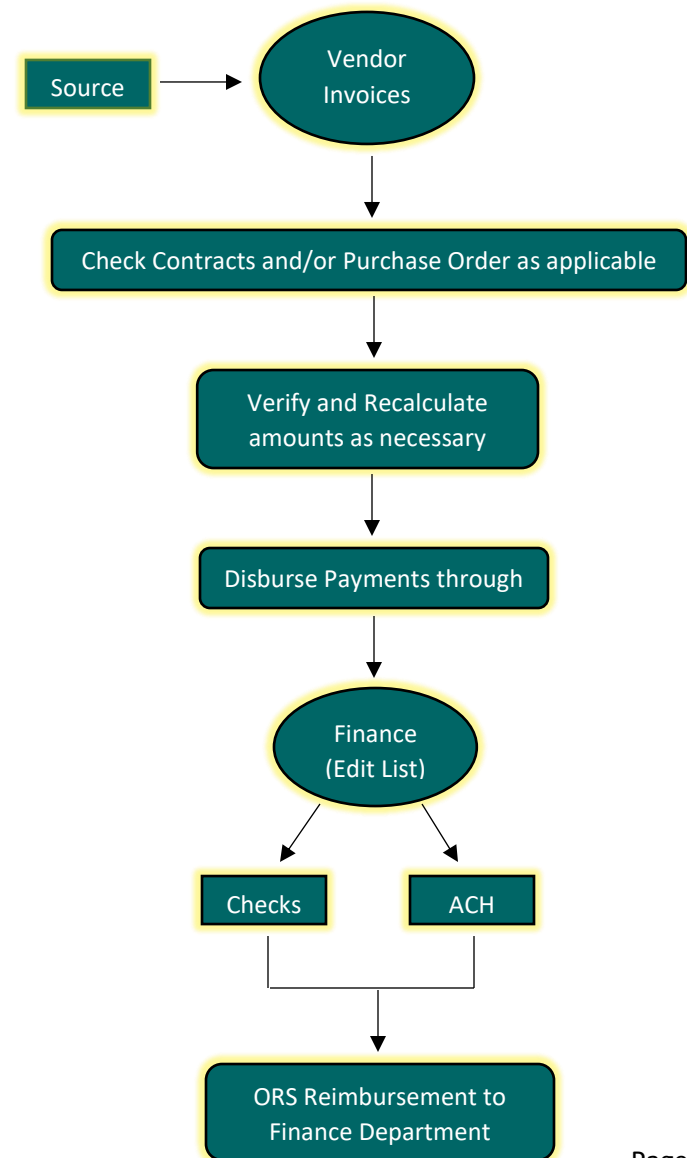
PENSION RELATED EXPENSES

(e.g., health care premiums, federal and state taxes, and retirees' membership associations)



OTHER OPERATING AND ADMINISTRATIVE EXPENSES

(e.g., investment advisory services, pension administration, and other general expenses)



Audit Objectives

The objective is to assess controls in the cash disbursements process other than benefit payments and determine whether transactions are authorized, approved, documented, and processed properly.

Audit Scope

The audit covers the following:

- a. Cash disbursement process design
- b. Documented policies and procedures
- c. Cash transactions for fiscal year 2018-2019
- d. ORS reimbursement process to finance department

The audit is limited to the processes within ORS. It does not include procedures and controls carried out by other departments such as Finance.

Audit Methodology

To perform the audit, the following procedures were performed:

General Procedures

1. Interviewed Accounting staff about the cash disbursement process other than retirement benefit payments and investment fundings.
2. Review of documented policies and procedures.
3. Assessment of controls over the payment process.
4. Analysis of cash transactions.

Specific Procedures

A. Pension related expenses

1. Sampled four months (August 2018, October 2018, February 2019, and May 2019) for pension related expenses.
2. Reviewed vendor payroll reconciliation and compared if amounts matched related documents and information.
3. Checked if material variances are explained and supported.
4. Verified if payments were made in a timely manner.
5. Traced payments to bank statements.
6. Determined if journal entries are posted timely and accurately.
7. Reviewed the reimbursement process.
8. Observed the review and approval process.

B. Other operating and administrative expenses

1. Tested 25 payments each for Federated and Police and Fire plans made within the covered period.
2. Checked the related contracts for accuracy of invoice amounts.
3. Recalculated invoice figures as applicable.
4. Verified if payments were made in a timely manner.
5. Traced payments to bank statements.
6. Determined if journal entries are posted timely and accurately.
7. Reviewed the reimbursement process.
8. Observed the review and approval process.

Audit Results

Based on the audit procedures performed, control strengths were identified, as well issues that should be addressed in order to improve the current process. Overall, Internal Audit observed good practices with ORS's administration of cash disbursements.

Control Strengths Identified

a. Access and Authorization

Only accounting staff has access to Financial Management System ("FMS") which is the City's accounting software. No other staff can initiate a vendor payment and subsequently create a cash journal entry without having to go to Accounting Division.

Check printing function in Pension Gold, the pension administration system, is only authorized to two designated staff in Accounting group (Account Clerk and Accountant I).

b. Segregation of Duties

Proper segregation of duties is implemented all throughout the process. No single individual can prepare, review, and approve vendor payments.

c. Review and Approval

There is a thorough review and approval process in place. At least two persons are required to perform the review of each step in the process – invoice amount verification, vendor payroll reconciliation, creation of edit lists and journal entries, actual payment, and reimbursement procedure.

d. Documentation

Appropriate and complete documentation are stored and maintained for all payments regardless of whether they are pension related or other operating and administrative expenses.

e. Accuracy and Reconciliation

For pension related expenses, a vendor payroll reconciliation is being performed. Current amounts are compared to prior month figures. All amounts are matched to other pension gold reports. If there are material variances between the current and prior month figures, the

differences are explained and substantiated by attaching related supporting information regarding the significant change.

For other operating and administrative expenses where the department is actually billed through invoices, amounts are reconciled to the most updated contracts and/or purchase orders. Based on the recalculation procedure, invoice figures are accurate and reasonable. There were no payments made wherein an amount exceeded the budgeted value from the contract.

f. Reimbursement Process

The updated reimbursement process implemented recently is now almost 100% based on actual cash expenses paid by Finance department on behalf of ORS. A short comparison is shown below.

Old Process

Cash Item	Basis
Retiree Payroll	12-month rolling average
Accounts Payable (includes all vendor payments for pension, operating, and administrative expenses)	12-month rolling average
Cash Collection Adjustments	Actual cash received in the current month
True-up	Prior month's actual vs estimated expenses

The old reimbursement process is based on a 12-month rolling average of expenses plus an additional amount as a buffer and adjusted for prior month's true-up and current cash collected.

New Process

Cash Item	Basis
Retiree Payroll	Actual benefit payment for the current month
Accounts Payable (includes all vendor payments for pension, operating, and administrative expenses)	Actual expenses recorded for the current month. Includes the following: <ol style="list-style-type: none"> 1. Expenses recorded and paid within the current month 2. Future payments that will be released next month – these pertain to expenditures already approved for payment but checks won't go out until the next month due to City's policy of cutting checks by batch only every Friday. It's basically a timing difference issue.
Return of contributions ("ROC")	Actual return of contributions within the month (sometimes an estimated amount is used if final amount is not yet available).
Employee Salary	Average two pay period salary
Cash Collection Adjustments	Actual cash received in the current month
True-up	Prior month's actual vs estimated expenses

The new process is still utilizing a 6-month rolling average for expenses but only for reference and comparison purposes only. As a result of implementing the new process, actual vs estimated expenses are much closer now (old process – million dollar true ups VS new process – few thousand dollar true ups). This reduces the risk of transferring cash from ORS's cash custody to the City's bank account that is too large or too little. Underpayment will pose an overdraft risk to Finance Department while overpayment will cause an investment opportunity cost to ORS.

g. Timeliness

In general, timeliness is a fundamental control emphasized in preparation and review of journal entries, vendor reconciliation, reimbursement process including wiring of funds, and vendor payments.

Below are the issues identified that should be addressed to further strengthen internal controls over the cash disbursement 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: From the samples selected for operating and administrative expenses, 13 out of 50 invoices were paid late (3 – 90 days late). Amounts vary from \$1,200 to \$42,000.

Reasons on why payments were late vary from – gap between invoice date and receipt of actual invoice, short invoice net terms (e.g., due date is 10 days after invoice date), and untimely review of invoice amounts. It is also important to take note that the City's Finance Department has a policy of cutting vendor checks by batch every Friday with a deadline of receiving proper and complete supporting documentation on Thursday, the week before the payment release.

It is essential to always pay vendors and suppliers on time to prevent certain risks from occurring such as late penalties, delay of delivery of goods and services, forfeited discounts, duplicate payments, broken business relationship, and damaged reputation.

Priority Rating: High

Recommendation #1: Internal Audit recommends strengthening the monitoring process for invoice payment process. While ORS cannot change vendor net terms and Finance Department's policy of processing payments, the following are some procedures that staff can do in order to minimize the risk of late payments.

- a. Communicate and highlight the importance of paying vendor invoices on a timely manner to all department staff including City policies and deadlines.
- b. Follow up with the appropriate personnel reviewing the invoice if it's being held up for an unreasonable amount of time. Initials as proof of review should also include date the action is performed.
- c. For invoices received via physical mail, request for an electronic copy through email. This will bridge the gap of not receiving the invoices on time.

Finding #2: Instruction to wire funds from ORS's cash custody bank (State Street) to the Finance Department's bank (Wells Fargo) for reimbursement purpose is done through a less secure channel which is by fax.

The wire letter includes confidential information (e.g., bank information). Sending instructions through fax poses more risk of the content being copied or hacked by someone else. Misdialed calls can also occur due to human error which can lead to transmission errors. Furthermore, audit trails are limited since fax machines can only store short transaction history reports.

Priority Rating: Moderate

Recommendation #2: Consider utilizing eCFM (electronic cash flow module) which is a more secure and efficient channel in sending wire instructions.

This cash management system embedded in the custodian's online portal is already being used for investment funding initiatives. Using this system will reduce data security risk as well as transmission errors. Automated controls are in place to better protect information.

The process will also be easier and more efficient since there will be no printed hard copies of either the wire letter or supporting documentation, required signatures are electronic, and no call backs are necessary. It will lessen the turnaround time from preparation, review, approval, and transmission process.

Finding #3: There is no threshold set for the month to month vendor payroll variance analysis.

Priority Rating: Low

Recommendation #3: Establish a percentage and dollar threshold amount that can be accepted without further investigation.

Setting the threshold for variance analysis is a matter of professional judgment but it's influenced primarily by the concept of materiality and desired level of assurance. Discussion within the Accounting Division is needed to determine the acceptable level by analyzing nature of the items, fluctuation trends, and other relevant information. By doing this, process will be more efficient since staff can focus more on variances that are significant. Less time will be designated in researching differences and supporting documents that will substantiate the changes in the monthly vendor payroll amounts.

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 cash 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	Cash Disbursement Process	3	2	1