

Internal Audit Department

O R A N G E C O U N T Y C A L I F O R N I A

AUDIT OF THE SOURCE OF FUNDING FOR THE 2004 OCEA PENSION ENHANCEMENTS

The Internal Audit Department determined that the Orange County Employees Association (OCEA) members themselves and **not** the County fully and accurately paid for the cost of the pension enhancements (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2005-06, 2006-07, & 2007-08, totaling \$80 million, which included additional employee contributions of \$46.4 million (as of February 28, 2008) and health insurance cost savings of \$33.6 million.

AUDIT NO: 2765
REPORT DATE: APRIL 3, 2008

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Internal Audit Department

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Internal Audit Department

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OC Fraud Hotline (714) 834-3608



Transmittal Letter



AUDIT NO. 2765 April 3, 2008

TO: Members, Board of Supervisors
Thomas G. Mauk, County Executive Officer

FROM: Dr. Peter Hughes, CPA, Director
Internal Audit Department

SUBJECT: Audit of the Source of Funding for the 2004
OCEA Pension Enhancements

We have completed our Audit of the Source of Funding for the 2004 OCEA Pension Enhancements to determine if the OCEA members fully paid for the cost of the 2.7% at age 55 benefit formula pension enhancements. The final report is attached for your review.

Please note we have a structured and rigorous **Follow-Up Audit** process in response to recommendations and suggestions made by the Audit Oversight Committee (AOC) and the Board of Supervisors (BOS). As a matter of policy, our **first Follow-Up Audit** will now begin at six months from the official release of the report. A copy of all our Follow-Up Audit reports is provided to the BOS as well as to all those individuals indicated on our standard routing distribution list.

The AOC and BOS expect that audit recommendations will typically be implemented within six months and often sooner for significant and higher risk issues. Our **second Follow-Up Audit** will now begin at 12 months from the release of the original report, by which time **all** audit recommendations are expected to be addressed and implemented.

At the request of the AOC, we are to bring to their attention any audit recommendations we find still not implemented or mitigated after the second Follow-Up Audit. The AOC requests that such open issues appear on the agenda at their next scheduled meeting for discussion.

We have attached a **Follow-Up Audit Report Form**. Your department should complete this template as our audit recommendation is implemented. When we perform our first Follow-Up Audit approximately six months from the date of this report, we will need to obtain the completed document to facilitate our review.

Each month I submit an **Audit Status Report** to the BOS where I detail any material and significant audit findings released in reports during the prior month and the implementation status of audit recommendations as disclosed by our Follow-Up Audits. Accordingly, the results of this audit will be included in a future status report to the BOS.

Letter from Director Peter Hughes



As always, the Internal Audit Department is available to partner with your staff so that they can successfully implement or mitigate difficult audit recommendations. Please feel free to call me should you wish to discuss any aspect of our audit report or recommendation.

Additionally, we will request your department complete a **Customer Survey** of Audit Services. You will receive the survey shortly after the distribution of our final report.

ATTACHMENTS

Other recipients of this report listed on the Internal Auditor's Report on page 5.

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2004 OCEA Pension Enhancements
Audit No. 2765*

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INTERNAL AUDITOR'S REPORT

AUDIT No. 2765

APRIL 3, 2008

TO: Members, Board of Supervisors
Thomas G. Mauk, County Executive Officer

FROM: Dr. Peter Hughes, CPA, Director
Internal Audit Department

A handwritten signature in blue ink that reads "Peter Hughes".

SUBJECT: Audit of the Source of Funding for the 2004 OCEA
Pension Enhancements

OBJECTIVES

The Internal Audit Department, at the request of the Board of Supervisors and the Audit Oversight Committee, conducted an audit of the source of funding for the 2004 OCEA pension enhancements (the "2.7% @ age 55" benefit formula). The objective of the audit was to determine if OCEA members' additional retirement contributions and related health insurance cost savings under the OCEA contracts of 2004 fully and accurately covered the cost of the pension enhancements for Fiscal Years 2005-06, 2006-07 & 2007-08. Our audit was conducted in accordance with professional standards established by the Institute of Internal Auditors.

RESULTS

The Internal Audit Department determined that the Orange County Employees Association (OCEA) members themselves and **not** the County fully and accurately paid for the cost of the pension enhancements (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2005-06, 2006-07, & 2007-08, totaling \$80 million, which included additional employee contributions of \$46.4 million (as of February 28, 2008) and health insurance cost savings (reduced employee healthcare benefits) of \$33.6 million.

The OCEA members paid additional employee retirement contributions of \$12.7 million for FY 2005-06 and \$19 million for FY 2006-07. For FY 2007-08, a total of \$14.7 million was paid through the end of our audit fieldwork (February 28, 2008, 18 pay periods), and the total contribution amount will increase at the end of this FY when the contributions of the remaining 8 pay periods are included. In addition, the reduced employee healthcare benefits resulted in health insurance cost savings of \$11.2 million per fiscal year.

Audit Highlight

The Internal Audit Department determined that the Orange County Employees Retirement Association (OCEA) members themselves and **not** the County fully and accurately paid for the cost of the pension enhancements (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2005-06, 2006-07, & 2007-08, totaling \$80 million, which included additional employee contributions of \$46.4 million (as of February 28, 2008) and health insurance cost savings of \$33.6 million.



We noted the following:

1. Orange County Executive Office/Office of Finance accurately computed the dollar amount due from OCEA's members to fully cover the Pension Enhancements of 2004 for Fiscal Years 2005-06, 2006-07 & 2007-08.
2. Orange County Executive Office/Office of Finance accurately included the health insurance cost savings concessions agreed to by OCEA in 2004 to the amount due from OCEA's members, in 2005-06, 2006-07 & 2007-08 for the Pension Enhancements of 2004.
3. Orange County Executive Office/Office of Finance correctly obtained an annual actuarial study of the benefit costs to determine if any adjustments were needed regarding the cost of the Pension Enhancements of 2004.

In addition, we found **no weaknesses in the pension cost calculations for OCEA's pension enhancements**. However, we did identify **two significant issues** to enhance controls as discussed in the Detailed Observations, Recommendations and Management Responses section of this report. See Attachment A for a description of Report Item Classifications.

BACKGROUND

The County of Orange is a participant of the Orange County Employees Retirement System (OCERS), which provides retirement benefits for employees of the County and certain districts. Retirement benefit costs are based on OCERS' actuarial study. Both the employer and employee (member) are required to make a mandatory contribution each payroll period to OCERS to fund the retirement plan. Based on the study, OCERS recommends to the County Executive Office/County Budget Office the employer contribution rates for the applicable fiscal year. The Orange County Board of Supervisors (BOS) approves and adopts the rates.

Pension Enhancement

In 2001, the California State Legislature passed Assembly Bill 616 that provided options for new retirement benefit formulas for public sector general members covered by both Public Employees' Retirement System (PERS) and 1937 Act Retirement Plans. One of the available formulas is known as 2.7 % @ 55. On August 24, 2004, the BOS adopted Resolution No. 2004-247 to implement a **2.7 % @ age 55** retirement formula for General Members of the OCERS retiring on or after July 1, 2005. This is the enhanced retirement plan for the OCERS General Members.



Source of Funding for Pension Enhancement

Under the 1937 Act, the employer and employees can agree that employees will pay a portion of the benefit cost that would customarily be employer cost. This arrangement is referred as “Reverse Pick Up”. Through negotiations with the labor organizations, e.g. Orange County Employee Association (OCEA), the bargaining units agreed that the pension enhancement would be without any additional cost to the County; therefore, they would make additional employee contributions (*Reverse Pick Up*) to the system.

Also, they agreed to the health benefit changes (increased co-payments, higher deductibles and increased employee payroll deductions). The combination of *Reverse Pick Up* and Health Insurance Cost Savings are required to cover the annual cost of implementing the Enhanced Retirement Benefits. In addition, there is an annual review of the enhanced benefits and costs to determine if any adjustments to the future Reverse Pick Up calculations are needed.

Reverse Pick Up

The Reverse Pick Up is calculated based on the cost of the enhanced retirement benefits, net of the health insurance cost savings (offset) to the County:

$$\begin{array}{rclcl} \text{Enhanced} & & \text{Health} & & \text{Reverse} \\ \text{Retirement} & - & \text{Insurance} & = & \text{Pick} \\ \text{Expense} & & \text{Savings} & & \text{Up} \end{array}$$

The reverse pick up rate in each of the bargaining units varies, as it is a result of the calculation and negotiations between labor organizations. The established rates are set forth in the corresponding Memorandum of Understanding (MOU). The County Executive Office/County Budget Office annually reviews the costs and adjusts the reverse pick up rate accordingly.

Enhanced Retirement Expense

The County requested OCERS to perform an Actuarial Study of the current and future annual costs for the enhanced retirement benefits for all general members. Towers Perrin, Actuary, performed the study as of December 31, 2004. Subsequently, the actuarial assumptions used by Towers Perrin were updated by The Segal Company, Actuary, to reflect the changes in the investment return assumption and a number of other actuarial assumptions adopted by the Board of Retirement. Bartel Associates, LLC, recommended using the ratio of total employer contribution rate increase from pre-enhancement in FY 2005/06 to the total employer contribution rate in FY 2005/06 (base year) as per the Actuarial Study Report for calculating the cost of the enhanced retirement for subsequent fiscal years. This methodology is known as ‘**Relative Ratio**’.



Using the relative ratio methodology, the County Executive Office/County Budget Office annually calculates the enhanced retirement rate based on the applicable actuarial valuation and review study.

Health Insurance Savings

The labor organizations agreed to the changes of health benefits effective January 1, 2005. The health insurance cost savings is calculated based on health cost pricing for the 2005 proposed health plans (increased co-payments, higher deductible and increased employee payroll deductions). In August 2004, Mercer, Health Benefit Consultant, performed the annual health insurance cost savings projection for the County. Subsequently, County Executive Office/County Budget Office updated the projection based on budgeted health insurance costs and employees' actual plan enrollment for FY 2005-06. It was determined that the health insurance costs savings was \$16 million per fiscal year (or a total of \$48 million for Fiscal Years 2005-06, 2006-07 & 2007-08). This savings was allocated to all bargaining units, which are affected by the health plan change. The allocation was based on the ratio of health insurance cost of each individual bargaining unit applicable to 2.7% @ 55 savings to the total health insurance cost. As a result, **OCEA members were allocated the amount of \$11.2 million per fiscal year (or a total of \$33.6 million for three Fiscal Years).**

SCOPE

Our audit was limited to evaluating the calculated additional employee contributions (Reverse Pick Up) and health insurance costs savings offset of selected OCERS General Members, associated with the implementation of the enhanced retirement plan. Our review covered six bargaining units of the Orange County Employees Association (OCEA), eligible for the 2.7% @ age 55 retirement benefits, during Fiscal Years 2005-06, 2006-07 and 2007-08. The bargaining units are: Community Services Unit (CS), County General Unit (GE), County Healthcare Professional Unit (HP), Office Services Unit (CL), Sheriffs Special Officer and Deputy Coroner Unit (SO), and Supervisory Management Unit (SM), totaling to approximately 11,700 employees (or 71% of County employment).

We did not assess the actuarial assumptions and projections by the actuary as the basis for the calculations of employer/employee pension contributions nor Mercer's health insurance costs savings determination. We did not review cost allocations for pension enhancements represented by other labor organizations, e.g. Orange County Attorney Association (OCAA); or other benefit formulas, e.g. 3% @ age 50. In addition, we did not review the calculations of prior agreements of employee and employer retirement contributions.



Our methodology included inquiry, auditor observation and examination, and testing of relevant documentation. In the course of conducting the audit, we interviewed personnel of various County departments, including CEO/County Budget Office, CEO/Public Finance, Human Resources Department/Employee Benefits and Auditor-Controller's Office; and consultants from actuary firms; Bartel Associates, LLC, for the enhanced pension cost adjustment, and Mercer for health insurance costs savings.

Acknowledgment

We appreciate the courtesy and cooperation extended to us during the audit by the personnel of the County Executive Office/Office of Finance, Human Resources Department/Employee Benefits and Auditor-Controller's Office. If we can be of further assistance, please contact me or Eli Littner, Deputy Director at (714) 834-5899 or Alan Marcum, Senior Audit Manager at (714) 834-4119.

Attachments

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

Members, Audit Oversight Committee
Carl Crown, Director, Human Resources and Employee Relations
Bob Franz, County Chief Financial Officer
Thomas Beckett, Director, County Executive Office/Public
Finance
Frank Kim, Director, County Executive Office/County Budget
Office
Patti Gilbert, Assistant Director, Human Resources/Employee
Benefits
Mitch Tevlin, Manager, County Executive Office/County Budget
Office
Foreperson, Grand Jury
Darlene J. Bloom, Clerk of Supervisors



DETAILED OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

Documented Operational Policies and Procedures (Significant Issues)

The Auditor-Controller's County Accounting Manual section S-2 – *Internal Control Systems*, states that departments/agencies are responsible for establishing written policies and procedures that supplement the policies and procedures in the Auditor-Controller's County Accounting Manual, to assure intended functioning of internal control systems. These policies and procedures should set forth in writing the specific procedures to be followed, and should be communicated and made available to all employees.

Observation No. 1

We noted that the policies and procedures were not established to document the development of employee's reverse pick up rate, the analysis of the health insurance costs savings and supervisory review and approval prior to its adoption. Also, we noted that supporting documents were missing or not readily available for our review. A substantial effort was made to obtain and collect the missing documents and analysis from reliable sources for our review. **(Significant Issue)**

Since the calculation of the reverse pick up rates is a complex process involving multiple components and requires collaborative efforts of several County and non-County agencies/organizations, written policies and procedures are needed to provide a tool for training new personnel, increased standardization of the process, clarification of responsibilities, and consistent application of management's expectations. In addition, **because of the criticality and Countywide impact**, it is important to maintain all supporting documents of the analysis and calculation. Ideally, documented policies and procedures should include:

- A list of documents, including appropriate descriptions of sources, content and purpose, required for the review and evaluation.
- Appropriate descriptions of routine procedures, but not necessarily limited to, detailed analysis, and review and approval.

Recommendation No. 1

We recommend the County Executive Officer establish written policies and procedures for documenting the development of the reverse pick up rates for all bargaining units, the analysis of the health insurance cost savings amount, assigning responsibilities for maintaining all the supporting documents; and determining the appropriate retention period.



County Executive Office Management Response:

The County Executive Office concurs. The County Budget Office will establish written policies and procedures by May 30, 2008 in accordance with the Auditor-Controller Accounting Manual (section S-2 – Internal Control Systems) to ensure all complex calculations resulting from negotiated benefits are properly documented with all relevant supporting documentation. The County Budget Office will obtain copies of any additional supporting documentation from the records assembled by the Internal Audit Department as a result of their review. Subsequent document retention timeframes will be in accordance with applicable County policies.

Observation No. 2

The labor contract agreements state that there is an annual review of the enhanced benefits and costs to determine if any adjustments to the reverse pick up are needed. Our audit found that the County Executive Office/County Budget Office performed the review. As a result, the employee's reverse pick up rates were adjusted annually. However, procedures were not established requiring documentation of the calculations to ensure its accuracy and approval. **Because of the significance of this process and its Countywide impact, we recommend having well-documented procedures. (Significant Issue)**

Recommendation No. 2

We recommend the County Executive Officer establish written policies and procedures for conducting the annual reviews of enhanced benefits and costs.

County Executive Office Management Response:

The County Executive Office concurs. In conjunction with Observation No. 1, the written policy the County Budget Office is developing will include a section requiring annual reviews, necessary adjustments or cost revisions, and management review before any changes are implemented.



ATTACHMENT A: Report Item Classifications

For purposes of reporting our audit observations and recommendations, we will classify audit report items into three distinct categories:

▶ **Material Weaknesses:**

Audit findings or a combination of Significant Issues that can result in financial liability and exposure to a department/agency and to the County as a whole. Management is expected to address "Material Weaknesses" brought to their attention immediately.

▶ **Significant Issues:**

Audit findings or a combination of Control Findings that represent a significant deficiency in the design or operation of processes or internal controls. Significant Issues do not present a material exposure throughout the County. They generally will require prompt corrective actions.

▶ **Control Findings and/or Efficiency/Effectiveness Issues:**

Audit findings that require management's corrective action to implement or enhance processes and internal controls. Control Findings and Efficiency/Effectiveness issues are expected to be addressed within our follow-up process of six months, but no later than twelve months.



ATTACHMENT B: County Executive Office Management Responses



County Executive Office

Memorandum

March 28, 2008

To: Peter Hughes, Internal Audit Department Director

From: Thomas G. Mauk, County Executive Officer

Subject: Internal Audit No. 2765 - CEO Management Response

The County Executive Office has completed and attached our management response to Internal Audit No. 2765 – Audit of Cost Allocations for OCEA Pension Enhancements. We concur with Observations #1 and #2 and have identified corrective actions to be implemented by May 30, 2008.

Should you have any questions or require additional information, please do not hesitate to contact me or Mitch Tevlin at 834-6748.

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2008 MAR 31 AM 8:26

Attachment

cc: Bob Franz, County Financial Officer
Thomas Beckett, Director, County Executive Office/Public Finance
Frank Kim, Director, County Executive Office/County Budget Office
Patti Gilbert, Assistant Director, Human Resources/Employee Benefits
Mitch Tevlin, Manager, County Executive Office/County Budget Office



ATTACHMENT B: County Executive Office Management Responses (continued)



**COUNTY EXECUTIVE OFFICE MANAGEMENT RESPONSE
TO OC INTERNAL AUDIT OF THE SOURCE OF FUNDING FOR THE
2004 OCEA PENSION ENHANCEMENTS (AUDIT NO. 2765)**

Observation No. 1

The County Executive Office concurs. The County Budget Office will establish written policies and procedures by May 30, 2008 in accordance with the Auditor-Controller Accounting Manual (section S-2 – Internal Control Systems) to ensure all complex calculations resulting from negotiated benefits are properly documented with all relevant supporting documentation. The County Budget Office will obtain copies of any additional supporting documentation from the records assembled by the Internal Audit Department as a result of their review. Subsequent document retention timeframes will be in accordance with applicable County policies.

Observation No. 2

The County Executive Office concurs. In conjunction with Observation No.1, the written policy the County Budget Office is developing will include a section requiring annual reviews, necessary adjustments or cost revisions, and management review before any changes are implemented.