ATTACHMENT A

Audit of Orange County Transportation Authority (OCTA) Payroll Transmittals

Report Date: November 12, 2018

Internal Audit Department

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Conclusion / Executive Summary

OCERS' Internal Audit Division has completed an audit of Orange County Transportation Authority (OCTA) payroll transmittals submitted between January 2016 and December 2017. Plan sponsors' payroll transmittals contain payroll data needed for OCERS to calculate a member's future benefit payment.

Internal Audit concludes that the OCTA's payroll transmittals were accurate and complete. However, Internal Audit has made one recommendation to OCERS' management, detailed in the report, in regards to Legacy[1] employees' vacation and/or sick pay cashouts.

Finding #1 (Efficiency/Effectiveness) – OCTA collects both employer and employee contributions for each Legacy employee's annual cashout of accrued vacation hours and/or accrued sick pay hours. However, this is contrary to most of OCERS' plan sponsors who do not collect any employer or employee contributions when a Legacy employee cashes out vacation hours and/or sick pay hours.

- Recommendation – OCERS should define a cashout contribution policy that applies uniformly across OCERS' plan sponsors and their Legacy employees on a go-forward basis.

The details of our findings, recommendations, and management's responses begin on page 5.

[1] Non-PEPRA employees.

Objective, Scope, and Methodology

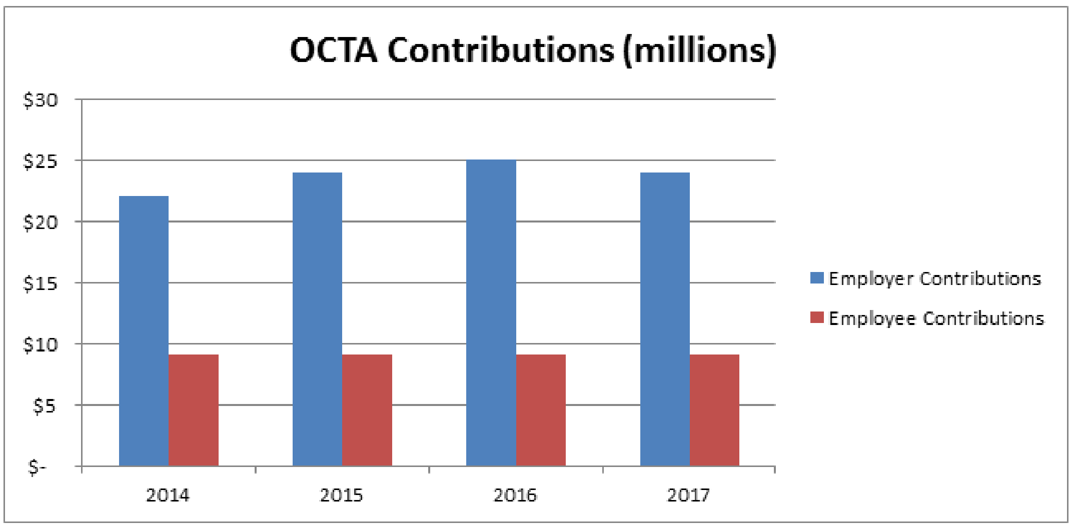
The objective of this audit was to determine that OCTA payroll transmittals submitted electronically to OCERS were accurate and complete.

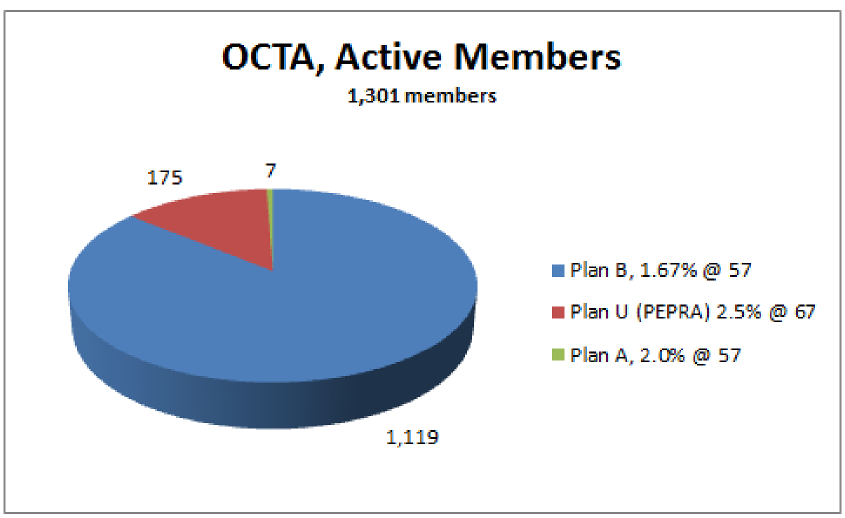
The scope of the audit included payroll transmittals submitted between January 2016 and December 2017. Internal Audit randomly selected a sample of 60 employee payroll transactions for detailed testing.

Appendix #1 details the audit testing methodology.

Background

The below charts show OCTA's recent employer and employee pension contribution history and active membership population:





For retirement purposes, FAS (Final Average Salary) calculations include base pensionable salary plus pensionable pay items. Since 2014, certain pensionable pay items paid by OCTA to its employees, averaged annually, are listed below:

- Scheduled (i.e. forced) Overtime Pay ($1.7 million)
- Special Merit Pay ($1.5 million)
- Certified Mechanic Pay ($166,000)
- Car Allowance Pay ($150,000)
- Night Shift Differential Pay ($131,000)
- Cell Phone Allowance Pay ($47,000)

The above items accounted for 85% of total premium pay items going back to 2014.

Contributions Related to Vacation and Sick Pay Sellbacks (i.e. Cashouts)

When an individual OCTA Legacy employee annually sells back (i.e., cashes out) accrued vacation hours and/or sick pay hours, both OCTA and the individual employee pay an employer and employee contribution on the cashout to OCERS. Also, when an individual OCTA Legacy employee terminates employment, both OCTA and the employee pay employer and employee contributions to OCERS on the cashout of any remaining vacation hours owed to the employee upon termination.

- OCTA's MOUs and its Personnel and Salary Resolution allow employees to annually sell back (1) up to 120 to 200 hours of accrued vacation hours; and (2) sick pay hours in excess of 80 to 120 accrued sick hours, depending on years of service and MOU or Personnel and Salary Resolution.

- Since 2014, Legacy employee cashouts have annually averaged $2.8 million from which both employee and employer contributions have been collected (approximately $950,000 using recent contribution rates).

OCTA's payroll manager indicated that its practice of collecting employer and employee contributions from Legacy employee cashouts has been in place since at least 2004, possibly earlier. OCTA collects contributions on every single hour of vacation pay or sick pay cashed out by a Legacy employee. **During the course of the audit, OCTA inquired of Internal Audit and OCERS' Member Services if OCTA's practice of collecting and paying contributions on vacation and sick pay cash outs by a Legacy employee (and on all vacation hours cashed out upon termination) is a correct practice for an OCERS plan sponsor.**

Member Services informed Internal Audit that the practice of collecting contributions from such cashouts varies across plan sponsors. See **Finding #1** that OCERS should define a cashout contribution policy that applies uniformly across OCERS' plan sponsors and their Legacy employees on a go-forward basis.

Findings, Recommendations, and Management Responses

Finding #1 (Efficiency/Effectiveness) – OCTA collects both employer and employee contributions for each Legacy employee's annual cashout of accrued vacation hours and/or accrued sick pay hours. However, this is contrary to most of OCERS' plan sponsors who do not collect any employer or employee contributions when a Legacy employee cashes out vacation hours and/or sick pay hours.

Finding Detail

OCERS' actuarial cashout assumption is one of several actuarial assumptions adopted by the OCERS Board upon recommendation from Segal. As a cost-sharing multiple-employer pension plan, OCERS generally applies these actuarial assumptions uniformly across all plan sponsors with some distinctions made for safety versus non-safety plan sponsors.

Specifically, OCERS' actuarial cashout assumption is used by Segal to adjust employer contribution rates and Legacy employee contribution rates. This adjustment "pays" for the actuarial cost of adding vacation pay and sick pay to a Legacy member's FAS calculation upon retirement[2]. For instance, applying the current cashout assumption of a 2.80% addition to FAS for all Legacy non-safety Tier 2 members regardless of employer has resulted in pension contribution costs to employers and Legacy employees that generally fall between:

- 0.3% to 1.4% of pay for employers[3]
- 0.2% to 0.3% of pay for employees

In addition to the above increases to contribution rates, OCTA **also** collects both employer and employee contributions for each individual Legacy employee cashout of accrued vacation hours and/or sick pay hours. **This practice is contrary to most of OCERS' plan sponsors (including the County of Orange) who do not collect contributions <u>at all</u> (i.e, neither upon annual cashout nor at termination) from individual Legacy employee cashouts of vacation and sick hours. For these other plan sponsors, the**

[2] Vacation and sick pay to the extent earned, not taken as time off, and permitted to be cashed out by the member's MOU for each year of the member's FAS measuring period.

[3] The change in the normal cost rate is spread over only payroll of General Tier 2 members while the change in the unfunded actuarial accrued liability rate is spread over payroll of General members in all Tiers within each Rate Group.

actuarial cash out assumption "pays" for the actuarial cost of adding vacation pay and sick pay to a Legacy member's FAS calculation upon retirement. Currently, OCERS has no system-wide policy that addresses this difference.

Recommendation to OCERS:

OCERS should define a cashout contribution policy that applies uniformly across OCERS' plan sponsors and their Legacy employees on a go-forward basis.

Management Response:

☒ Agree ☐ Disagree

OCERS is in the process of reviewing and evaluating all pay items in order to categorize and document in policy each item of compensation earnable for Legacy members and pensionable compensation for PEPRA members. OCERS intends to present this policy to the OCERS Board for review and approval by 1st quarter of 2019.

The majority of OCERS' plan sponsors do not apply the contribution rates to cashouts (as does OCTA); instead, they rely on the actuarial cash out assumption (Load Factor) to pay for the actuarial cost of adding vacation pay and sick pay to a Legacy member's FAS calculation upon retirement. OCERS believes this is the better approach and will incorporate this in the new policy in order to have consistency among all plan sponsors. In addition to the new policy, by 1st quarter of 2019, OCERS intends to distribute a circular letter to all plan sponsors informing them of this approach to not collect contributions on these cashouts.

Categories of Audit Findings:

Critical Control Weaknesses:

These are finding(s) that represent critical exceptions to the audit objective(s) and/or business goals. Such conditions may involve either actual or potential large dollar errors or be of such a nature as to compromise OCERS' reputation or integrity. Management is expected to address Critical Control Weaknesses brought to their attention immediately.

Significant Control Weaknesses:

These are finding(s) that represent a significant deficiency in the design or operation of internal controls. Management is expected to address Significant Control Weaknesses brought to their attention promptly.

Findings:

These are finding(s) concerning (1) internal control, (2) compliance, or (3) efficiency/effectiveness issues in which Internal Audit will recommend to management a corrective action to implement or enhance processes and/or internal controls. Findings are expected to be addressed within six to twelve months.

Appendix #1

Audit Testing Methodology

- Reviewing sections within OCTA MOU's (Memorandum of Understanding) in regards to the OCERS pension plan and OCTA pay practices.
- Verifying members' age of entry in V3 against executed Member Affidavits and Reciprocity verification documents.
- Recalculating employer and employee contributions submitted on OCTA transmittals against Segal's entry-age contribution.
- Tracing employer and employee contributions from OCTA transmittals to V3 records and copies of OCTA employee paystubs.
- Tracing pensionable salaries and pensionable pay items from OCTA transmittals to public pay schedules, employee work history records, and certification documentation maintained by OCTA's Human Resources department.
- Recalculating pensionable pay items on the transmittals against relevant terms stated in MOU's.
- Stratifying pensionable pay items by total per year, and by pay item, going back to the beginning of 2014.
- Reviewing a listing of pay codes in OCTA payroll system to search for pensionable pay items not reported to OCERS.
- Reviewing employee paystubs in our sample of 60 employees for pensionable pay items not reported to OCERS.
- Reviewing final average salary history of recent OCTA retirees for possible signs of pension spiking.
- Consulting with Segal about any actuarial issues.