

Internal Audit Department

O R A N G E C O U N T Y
5th Largest County in the USA

**Critical
Impact
Audit**

AUDIT OF COUNTYWIDE PENSION PRACTICES

For the Three Years Ending
June 30, 2009

We audited retirees (36 out of 781) who received cumulative salary increases greater than 10% in total for the three years prior to their retirement in order to identify if “questionable personnel actions” took place that increased or spiked the employee’s pension.

Given our criteria we found that overall 99.62% (778 out of 781) of the retirees did not receive questionable promotions and salary increases. In addition, all promotions and salary increases for the 36 retirees subject to our audit complied with the County policies and procedures and possessed all required documentation, approval and support.



However, we found two additional questionable instances of unusually high “End-of-Career” promotions and salary increases similar to the one instance identified by the Grand Jury. Our recommendation to address these types of instances is to require the approval of the Board of Supervisors for all proposed salary increases in excess of 15%. In addition, Orange County Human Resources should strengthen controls over monitoring salary increases.

AUDIT NO: 2913
REPORT DATE: MARCH 26, 2010

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Deputy Director: [Eli Littner, CPA, CIA](#)
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RISK BASED AUDITING

GAO & IIA Peer Review Compliant – 2001, 2004, 2007

-  2009 Association of Certified Fraud Examiners' Hubbard Award to Dr. Peter Hughes For the Most Outstanding Article of the Year
-  2008 Association of Local Government Auditors' Bronze Website Award
-  2005 Institute of Internal Auditors' Award for Recognition of Commitment to Professional Excellence, Quality, and Outreach

 ORANGE COUNTY BOARD OF SUPERVISORS'
Internal Audit Department

GAO & IIA Peer Review Compliant - 2001, 2004, 2007

Providing Facts and Perspectives Countywide

RISK BASED AUDITING

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OC Fraud Hotline (714) 834-3608



Transmittal Letter



Audit No. 2913 March 26, 2010

TO: Carl H. Crown, Director
Human Resources Department

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

SUBJECT: Audit of Countywide Pension Practices

We have completed an Audit of Countywide Pension Practices for the three years ending June 30, 2009, to determine if instances of questionable pension practices, such as pension spiking, have occurred in the County. We performed this audit in response to a recommendation in the Orange County Grand Jury report titled: *The Guardian of Last Resort* on the Public Administrator/Public Guardian, dated May 6, 2009.

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 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 begin at six months from the release of the first Follow-Up Audit 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 recommendations are 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.

Letter from Dr. Peter Hughes, CPA



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.

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 recommendations.

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 are listed on the **OC Internal Auditor's Report** on page 4.

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Pension Practices
Audit No. 2913*

For the Three Years Ending
June 30, 2009

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Audit No. 2913

March 26, 2010

Audit Highlight

In response to a Grand Jury recommendation, we audited retirees who received cumulative salary increases greater than 10% in total for the three years prior to their retirement. These selection criteria resulted in a review of 36 retirees (4.6%) out of a total of 781 retirees.

We found 99.62% of the retirees, 778 of 781, did not receive questionable promotions and salary increases. These "End-of-Career" promotions and salary increases complied with County policies and procedures and were properly documented, approved and supported. However, we found two additional questionable instances similar to the one instance identified by the Grand Jury.

TO: Carl H. Crown, Director
Human Resources Department

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

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

SUBJECT: Audit of Countywide Pension Practices

OBJECTIVES

We performed an audit of certain Human Resources records and related documents for the period from July 1, 2006 through June 30, 2009, to respond to the recommendation made to the Internal Audit Department in the Orange County Grand Jury report title "The Guardian of Last Resort" on the Public Administrator/Public Guardian, dated May 6, 2009. Our audit objectives in this review are:

- (1) Determine if additional instances of questionable pension practices exist in agencies other than the Public Administrator/Public Guardian's office.
- (2) Identify internal control weaknesses for which we will provide recommendations for improvement.

BACKGROUND

Questionable pension practices ("Pension Practices") are a group of unapproved processes whereby public sector employees receive larger than typical pay raises or other benefits that significantly increase their compensation at their "End-of-Career." Depending on the amount of the salary increase and the years of service credited, the additional pension payout could amount to millions of dollars over their remaining lifetime for a single County retiree. Such salary increases are of concern because: (1) they create large unfunded pension liabilities that are not paid by the benefitting retired employees and must be paid by future payroll withholdings from non-retired employees and contributions from the County; and (2) management may not understand the long-term consequences and total cost impact of a pay increase at the employee's "End-of-Career."



A current example of both of the concerns was recently reported in the *Contra Costa Times* on January 10, 2010 involving a County Administrator who served for 2½ years in the position. As a consequence of the promotion for the former County Administrator, the retiree will receive an extra \$92,000 more in his \$240,000 annual pension for the rest of his life. The *Contra Costa Times* reported “Supervisors didn’t consider that when they approved Cullen’s (former County Administrator) contract. We didn’t think about the pension implications,” said Supervisor John Gioia of Richmond.

Grand Jury Report – The Guardian of Last Resort

The Orange County Grand Jury reviewed the Public Administrator/Public Guardian’s Office. The Orange County Grand Jury’s report titled: *The Guardian of Last Resort*, dated May 6, 2009, stated concerns in the areas of financial accountability, policies and procedures, personnel administration, information technology, and case management.

Additionally, the Orange County Grand Jury reported questionable pension “spiking” practices. Their report cited a case wherein an employee was promoted to a top management position within a year of retirement. The position was at will and had no specific educational and experience requirements. The Grand Jury’s report stated, in part, that this one year promotion of 57% for the employee is costing an additional \$56,674 per year in pension benefits and based on Internal Revenue Service life expectancy tables for this employee, the total additional payout will exceed \$1,453,100.

Their report contained the following recommendation:

R.4 – The County Internal Audit Department should conduct an in-depth review of OCHR personnel records to determine if additional instances of questionable pension practices exist in agencies other than the PA/PG office. The audit report and any resulting County responses will be forwarded to the Grand Jury for information.

Authorization of the Audit

The audit of Countywide Pension Practices was included within the Annual Audit Plan for fiscal year 2009-2010. The Audit Plan is submitted, discussed, and approved each fiscal year by the Audit Oversight Committee. The membership of the committee includes the Chairman and Vice-Chairman of the Board of Supervisors, the Auditor-Controller, the County Executive Officer, a member from the private sector appointed by the Board, and the Treasurer-Tax Collector as an ex-officio (non-voting) member. The Annual Audit Plan for fiscal year 2009-2010, including the audit of Countywide Pension Practices, was approved by the Audit Oversight Committee on May 27, 2009.

SCOPE

Our audit evaluated Countywide Salary and Promotion Practices for retirees for the period from July 1, 2006 through June 30, 2009. We audited the Human Resources Department’s personnel records and related documents to determine the instances of questionable salary increases occurring in the County. Our audit conforms with the International Standards for the Professional Practice of Internal Auditing. Our methodology included inquiry, auditor observation and testing of relevant documents. We found 781 retirees during the three year audit period. Of this group of 781, we performed test work on all 36 selected retirees who received cumulative salary increases greater than 10% in total for the three years prior to their retirement.



SCOPE EXCLUSIONS

We did not audit the County's defined benefit pension plan or information technology controls over the pension information sent to the Orange County Employee's Retirement System (OCERS), the County's pension administrator. In addition, while we audited the practices for base salary and wage increases we did not audit other elements such as overtime; compensatory time; payoffs of vacation, sick leave and holidays and allowances.

RESULTS

Below are the results of our audit:

Objective #1: Determine if additional instances of questionable pension practices exist in agencies other than the Public Administrator/Public Guardian's office.

Results: We found two questionable promotions and salary increases in two County departments which impacted pensions upon retirement between July 1, 2006 and June 30, 2009. One promoted employee had a salary increase of 60% and another promoted employee a salary increase of 21% (See page 5 for details).

Objective #2: Identify internal control weaknesses for which we will provide recommendations for improvement.

Results: We found OCHR policies are adequate for 99.62% of the compliant salary increases awarded to the County workforce. However, the Grand Jury identified questionable promotion and salary actions for one retiree from the Public Administrator/Public Guardian's office. Our review disclosed two additional retired employees from two County departments with similar promotion and salary increase issues. Consequently, our recommendation is to mitigate the three questionable salary increases because allowing such actions is detrimental to the significant majority of the compliant salary increases (See pages 5 through 7 for details).

Management's Responsibilities for Internal Controls

In accordance with the Auditor-Controller's County Accounting Manual section S-2 - *Internal Control Systems*, "All County departments/agencies shall maintain effective internal control systems as an integral part of their management practices. This is because management has primary responsibility for establishing and maintaining the internal control system. All levels of management must be involved in assessing and strengthening internal controls. Control systems shall be continuously evaluated and weaknesses, when detected, must be promptly corrected." The criteria for evaluating an entity's internal control structure is the Committee of Sponsoring Organizations (COSO) control framework. Our Internal Control Audit enhances and complements, but does not substitute for the Human Resources Department's continuing emphasis on control activities and self-assessment of control risks.



Inherent Limitations in Any System of Internal Control

Because of inherent limitations in any system of internal controls, errors or irregularities may nevertheless occur and not be detected. Specific examples of limitations include, but are not limited to, resource constraints, unintentional errors, management override, circumvention by collusion, and poor judgment. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or the degree of compliance with the procedures may deteriorate. Accordingly, our audit would not necessarily disclose all weaknesses in the Human Resources Department's operating procedures, accounting practices and compliance with County policy.

Acknowledgment

We appreciate the courtesy extended to us by the Human Resources Department. If we can be of further assistance, please contact me directly or Eli Littner, Deputy Director at 834-5899 or Alan Marcum, Senior Audit Manager at 834-4119.

Attachments

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

- Members, Board of Supervisors
- Members, Audit Oversight Committee
- Thomas G. Mauk, County Executive Officer
- Shelley Carlucci, Assistant Director, HR/Administration
- Bob Leys, Assistant Director, HR/Services and Support
- Diane Greek, Manager, HR/Services and Support
- Foreperson, Grand Jury
- Darlene J. Bloom, Clerk of the Board of Supervisors



Objective #1: Determine if additional instances of questionable pension practices exist in agencies other than the Public Administrator/Public Guardian's office.

Finding No. 1 – Questionable Promotion and Salary Increases (Control Finding)

To review whether questionable pension practices exist, we considered the salary increases granted to 781 employees retiring from July 2006 through June 2009. We analyzed the salary increases and evaluated a group of 36 employees who received cumulative salary increases greater than 10% in total for the three years prior to their retirement. Our primary focus was to determine whether these salary and promotion actions complied with County policy.

During our review of a sample of employee salary increases, we identified two instances where employees received a promotion and large "End-of-Career" salary increases at departments other than the Public Administrator/Public Guardian's Office. Based upon our review of documentation, the two promotions and salary increases did not technically violate HRD policies and procedures, but were questionable management actions. We found that one promoted employee had a salary increase of 60% and another promoted employee a salary increase of 21%.

It should be noted that the three instances of questionable promotion and salary increase represent a negligible portion of the retirees with 778 of the 781 (99.62%) not open to such apparent challenge.

Recommendation No. 1

The Human Resources Department advise all appropriate levels of management on the impact of salary increases and future pension costs.

Human Resources Department Management Response:

Partially Concur. Although the three questionable actions are within policy, the circumstances surrounding these actions and lack of documentation do allow for the decisions to be called into question. However, County department executives and department human resources managers are usually not aware of a person's retirement intentions since the employee is not obligated to provide advance notice of their intended retirement date. The compliance rate as stated in the findings, 99.62%, indicates that "end of career" salary increases are overwhelmingly in compliance with both the letter and intent of County Policy. Based on the very high compliance rate an educational effort is not necessary.

Objective #2: Identify internal control weaknesses for which we will provide recommendations for improvement.

Finding No. 2 – Authorization of Salary Increases (Control Finding)

Salary increases should be authorized and executed only by persons acting within the scope of their authority. Authorization of a salary increase is management's decision to commit resources for specific purposes under specific conditions. It is the principal means of assuring that only valid salary increases are entered into. Authorization should be clearly communicated to all personnel and should include the specific conditions and terms under which authorizations are to be made. Conforming to the terms of an authorization means that personnel are carrying out their assigned duties in accordance with directives and within the limitations established by management.



The lack of appropriate authorization for salary adjustments increases the risk of errors, irregularities, and misappropriation of funds.

The *Personnel and Salary Resolution* approved by the Board of Supervisors in January 2003 contains a maximum salary increase on promotion to a management range of up to 15% upon the recommendation of the department head and the approval of the County Executive Officer.

However, it was noted that the County **discontinued requiring** the County Executive Officer to authorize salary increases exceeding 15% on promotion and according to the current collective bargaining agreement permits a management position to be filled at any rate within the salary range.

Our assessment on this report item is the authorization from the County Executive Officer of a salary increase exceeding 15% is a sound business practice and should be reestablished and expanded to include the Board of Supervisors.

As noted earlier, there were three instances of retirees receiving unusually large one-time salary increases representing a negligible portion of the retirees with 778 of the 781 (99.62%) receiving one-time salary increases not above the 15% threshold.

Recommendation No. 2

The Human Resources Department require pre-authorization of permanent and temporary promotions from the County Executive Officer for proposed and/or cumulative salary increases exceeding 15% prior to submission to the Board of Supervisors for their review and approval.

Human Resources Department Management Response:

Partially Concur. The referenced Personnel and Salary Resolution covers only non-represented employees in the County. All management employees are covered under the collective bargaining agreement that allows for the Department Head to consider external factors when filling a vacant position. However, the Human Resources Department will develop with the CEO's office a process that will require CEO or designee's approval for all non-negotiated salary increases above 15% for Law Enforcement Management, Executive Management, and Administrative Management employees.

Finding No. 3 – Monitoring Salary Decisions (Control Finding)

Monitoring salary increases must be provided to ensure that management's objectives are achieved. Effective monitoring of salary increases requires continuous review of personnel actions. When necessary and appropriate monitoring controls over salary increases are not sufficiently documented and reviewed, there is an increased risk that errors, misunderstandings, and improper practices will not be detected and eliminated.

In addition, monitoring salary decisions should be clearly documented. Documentation of the monitoring system should include identification of the policies considered and related techniques completed to evaluate compliance. Documentation of monitoring salary decisions should be complete and accurate and should facilitate an assessment of the control from before it occurs, while it is in process, to after it is completed.



We found that the Human Resources Department prepares a periodic report of all administrative management and law enforcement management salary actions to review for compliance with policies and procedures. A sample of salary actions is selected for compliance review and evaluated for compliance with policies and procedures through a review of electronic personnel records. At the Human Resources Department, we determined that periodic reports are maintained with checkmarks adjacent to individual management salary actions and informed the management salary actions with checkmarks were reviewed. However, we found documentation was not maintained to evidence:

- The specific policy or procedure evaluated and the level of compliance.
- The information obtained and the conclusions reached.
- The supervisory reviews of the compliance evaluations.
- The follow-up of any corrective action.

Recommendation No. 3

The Human Resources Department take appropriate actions to ensure monitoring of management salary increases are documented, reviewed and maintained on file for third party confirmation.

Human Resources Department Management Response:

Concur. The Human Resources Department will require that documentation be placed in the personnel file of all employees who receive salary increases through negotiated processes such as Market/Equity adjustments and/or Performance Pool increases for all eligible units: Administrative Managers, Law Enforcement Management and Executives.



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:

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



ATTACHMENT B: Human Resources Department Management Responses



Human Resources Department

Memorandum

RECEIVED
INTERNAL AUDIT DEPARTMENT

2010 MAR 23 AM 8:23

March 22, 2010

To: Dr. Peter Hughes, Director of Internal Audit

From: Carl H. Crown, Human Resources Director

Subject: Response to Draft Report on Countywide Pension Practices

The Human Resources Department (HRD) has completed our review of your draft report from the recent audit regarding the pension practices of the County per the recommendation of the Grand Jury report titled: *The Guardian of Last Resort*.

Our responses to the recommendations are as follows:

Finding No. 1 – Questionable promotion and salary increases - Internal Audit reviewed salary increases granted to 781 employees who retired between July 2006 and June 2009. Of the 781, three were found to be questionable. The remaining 778 were found to be within current policy

Recommendation No. 1 – The Human Resources Department advise all appropriate levels of management on the impact of salary increases and future pension costs.

Response: Partially Concur

Although the three questionable actions are within policy, the circumstances surrounding these actions and lack of documentation do allow for the decisions to be called into question. However, County department executives and department human resources managers are usually not aware of a person's retirement intentions since the employee is not obligated to provide advance notice of their intended retirement date. The compliance rate as stated in the findings, 99.62%, indicates that "end of career" salary increases are overwhelmingly in compliance with both the letter and intent of County Policy. Based on the very high compliance rate an educational effort is not necessary.



ATTACHMENT B: Human Resources Department Management Responses

Countywide Pension Practices
March 22, 2010
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Finding No. 2 – Authorization of Salary Increases - Salary increases should be authorized and executed only by persons acting within the scope of their authority. The Personnel and Salary Resolution was approved by the Board of Supervisors in January 2003 and contains a maximum salary increase on promotions to a management range of up to 15%, upon the recommendation of the department head and the approval of the County Executive Officer (CEO). The County discontinued requiring the County Executive Officer to authorize salary increases exceeding 15% on promotion and according to the current collective bargaining agreement permits a management position to be filled at any rate within the salary range.

Recommendation No. 2 – The Human Resources Department require pre-authorization of permanent and temporary promotions from the County Executive Officer for proposed and/or cumulative salary increases exceeding 15% prior to submission to the Board of Supervisors for their review and approval.

Response: Partially Concur

The referenced Personnel and Salary Resolution covers only non-represented employees in the County. All management employees are covered under the collective bargaining agreement that allows for the Department Head to consider external factors when filling a vacant position. However, the Human Resources Department will develop with the CEO's office a process that will require CEO or designee's approval for all non-negotiated salary increases above 15% for Law Enforcement Management, Executive Management, and Administrative Management employees.

Finding No. 3 – Monitoring Salary Decisions – The Human Resources Department prepares a periodic report of administrative management and law enforcement management salary actions for review to ensure compliance with policies and procedures. However, Internal Audit found that documentation was not maintained to evidence: the specific policy or procedure and the level of compliance; the information obtained and the conclusion reached; the supervisory reviews of the compliance evaluations; and the follow-up of any corrective action.

Recommendation No. 3 – The Human Resources Department take appropriate actions to ensure monitoring of management salary increases are documented, reviewed and maintained on file for third party confirmation.



ATTACHMENT B: Human Resources Department Management Responses

Countywide Pension Practices
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Response: Concur

The Human Resources Department will require that documentation be placed in the personnel file of all employees who receive salary increases through negotiated processes such as Market/Equity adjustments and/or Performance Pool increases for all eligible units: Administrative Managers, Law Enforcement Management and Executives.

Should you have any questions or need additional information, please contact Bob Leys, Assistant Human Resources Director, at (714) 834-5314. Thank you for you and your staff's support during this audit.

cc: Thomas G. Mauk, County Executive Officer
Bob Leys, Assistant Human Resources Director - Services and Support