

**PUBLIC PENSION SYSTEMS**

**Operational Risks of  
Defined Benefit and Related Plans  
and  
Controls to Mitigate those Risks**

**July 2003**

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### **FOREWORD**

In July 2000, a group of public pension fund chief investment officers and the Association of Public Pension Fund Auditors (APPFA) issued *Public Pension Systems – Statements of Key Investment Risks and Common Practices to Address Those Risks*. While much of the emphasis in pension funds is on investment risks, the administrative and benefits (non-investment) side of pension systems also face an extraordinary number of risks as well.

In light of the broad acceptance and usefulness of the investment risk document by public pension systems nationwide, APPFA decided that it would be beneficial to look at non-investment risks that systems face. APPFA appointed a committee comprised of the following members to work on this project:

Richard Bendall, co-chair	Los Angeles County Retirement Association
Vicki Wickliffe, co-chair	Wisconsin Retirement System
Robert Benson	California Public Employees Retirement System
Jeanette Eckert	Louisiana State Employees Retirement System
Janet Harris	Public School Retirement System of Missouri
Jamie-Lyn Kinsella	North Dakota Public Employees Retirement System
Dennis Trzeciak	Ohio School Employees Retirement System

Tom Britting, APPFA's president, conducted a brainstorming session with the APPFA Board at the May 2002 meeting in Williamsburg, Virginia to determine the dynamics of the project. It was agreed that an outline would be presented to the Board at the November 2002 meeting and a first draft would be completed by the May 2003 APPFA meeting. The committee agreed to keep the Board apprised of the progress on the project and obtain Board input.

Work on the project was completed by individual members of the committee with periodic e-mails and telephone meetings among committee members.

### **INTRODUCTION**

Public pension systems (Systems) face a large number of risks on the administrative and benefits side of the business. Some inherent risks do not change much over time. However, other risks and the mitigating controls for all risks are often affected by the constant changes in technology and the environment in which Systems operate. This document lists some of the risks that public pension funds face and some of the controls that may be put in place to mitigate these risks. This document does not address risks related to health insurance, life insurance, income continuation insurance, and other such benefits that may be administered by third party administrators and does not address post employment benefits not specifically listed in this document.

This document is intended to provide a point of reference or a guide to auditors or system administrators and other pension fund staff in addressing risks and practices and procedures to address those risks. In other words, this document is intended as a template for analyzing and addressing risks faced by individual public pension systems. Accordingly, it identifies key administrative risks associated with all public pension systems and common practices to address, manage, and, to the extent possible, control those risks. While common practices may be appropriate for most Systems, in some instances an individual fund's posture or resources might require lesser or greater actions, given the fund's analysis of the potential impact of a particular risk and the cost (including time and complexity) of fully addressing that risk. Common practices only address common

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situations. To the extent that each fund has unique situations distinguishing it from others, examples in this document would not be applicable.

It should be understood this document is not intended to be an exhaustive list of all risks that public pension systems may potentially encounter. Nor is it intended to be a comprehensive checklist of all the controls and other procedures a public pension system should incorporate to address the identified risks. The practices listed in this document are simply common and proven approaches that may help Systems assess their approach to addressing similar issues. They are termed “action points of focus.” They are things that can be done to mitigate risk; but there may be numerous alternative methods and procedures to address the identified risks effectively. Consequently, the description of the key risks and possible actions are intended as examples, not as standards or prescriptions.

We recognize that this document might be used as a resource during periodic audits of public pension systems. If so, the auditor should keep in mind that this document only describes existing common practices, not necessarily best practices. There are usually many ways and, in the context of specific Systems, there might be better ways to address the risks described. The primary question is whether the actions taken by the pension fund effectively mitigate the risk, and not whether they follow the examples published in this report. An auditor must also be mindful of the concepts of materiality of the risk being addressed and cost/benefit analysis in determining the adequacy of the actions taken.

This document is presented in top down order of responsibility for the system— beginning with the legislative authorities, the board, audit committee, executive management, etc. Then the document continues to present the risks and controls in order of the members' life cycle in the system.

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### **I. Legislation/Legal Actions/Court Decisions**

#### **A. *State Plans and Stand-Alone Local Agency Retirement Plans***

##### **1. Risks**

- Risk that the plan is not implemented in conformance with existing federal/state laws
- Risk that statutory language is difficult to interpret
- Risk that the plan is complicated, making the system expensive to administer and increasing inherent risks
- Risk that changes required by new federal/state laws or court decisions will not be implemented
- Risk that legislators/government body(ies) will enact laws/resolutions having a negative impact on the pension system
- Risk that legislators/government body(ies) will enact laws without the involvement of actuaries, the Board, and/or pension system management
- Risk that legislative/government body actions will present legal challenges to the pension system
- Risk that legislative/government body actions will change pension benefits and contributions and materially impact funding principles
- Risk that plan cannot fund itself
- Risk that implementation of new legislation is costly
- Risk that new legislation requires large amounts of time, has a time constraint which is difficult to meet, or cannot be implemented timely
- Risk that new legislation/ordinances/resolutions cannot be implemented because of information technology constraints
- Risk that individual employers pass ordinances or negotiate employment contracts that conflict with pension system statutes and rules
- Risk that knowledge is not transferred to new legislators when there is turnover in legislators

##### **2. Controls to mitigate the risks**

- Provide a competent Board, good Board governance, competent staff, appropriate hiring practices, a competent legal office, and appropriate legal counsel
- Hire a competent Legislative Liaison to ensure the Board and management are aware of upcoming and pending legislative/governing body actions
- Draft legislation/resolutions for consideration by legislature/government body
- Prepare analyses of, and respond to, legislative/governing body initiatives
- Utilize consultants to analyze impact of proposed legislation
- Provide information and education to the governing body concerning the amounts of time and money to implement proposed legislation, and an analysis of time and information technology constraints
- Participate in orientation for new legislators
- Perform employer audits
- Utilize e-mail or work with appropriate associations to educate employers about new and pending legislation

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### ***B. Local Public Agency Plans Contracting with a Public Pension System***

#### **1. Risks**

- Risk that contract with public agency does not conform with existing federal/state laws
- Risk that new local ordinances and Memoranda of Understanding (MOUs) conflict with applicable State laws and regulations
- Risk that eligible public agency is rejected or an ineligible entity is accepted
- Risk that employment contracts are not in compliance with laws or regulations
- Risk that contracted benefits with public agencies are diverse and complicated, making the system expensive to administer and increasing inherent risks
- Risk that individual employer risk pools are so small as to pose a risk to individual public agencies and/or local taxpayers
- Risk that plan contract does not incorporate changes required by new federal/state laws or court decisions
- Risk that staff turnover of benefit officers at public agencies will adversely affect communications with both the employer and the members

#### **2. Controls to mitigate the risks**

- Utilize legal counsel to ensure contract conforms with existing federal/state laws and that contracts have provisions for, or are amended appropriately for, changes in federal/state laws
- Provide information and education to public agencies about provisions of applicable laws and regulations
- Provide ongoing training to benefit staff at the public agencies
- See list of controls to mitigate the risks in section I.A.2.

## **II. Administration**

### ***A. Board of Trustees***

#### **1. Risks**

- Risk that Board members are not adequately trained and qualified to perform their functions and fiduciary responsibilities
- Risk that Board members do not meet frequently enough to perform their functions and fiduciary responsibilities
- Risk that Board members do not have expertise to promulgate policies for a public pension plan
- Risk that Board members do not select qualified executives
- Risk that Board members micro-manage the public pension plan
- Risk that one or more Board members may not be independent and/or may have a conflict of interest and/or may not be performing their fiduciary duties solely for the benefit of members, retirees, and beneficiaries
- Risk that Board members are not provided sufficient and/or timely information by pension system managers in order to make informed decisions

#### **2. Controls to mitigate the risks**

- Provide orientation and training for new Board members
- Provide continuing education for Board Members
- Send background/resource information timely to Board members before meetings

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- Hire a Board Coordinator to coordinate Board activities and ensure that Board members receive timely and appropriate information
- Write a mission statement
- Conduct or have a periodic fiduciary audit
- Develop an Ethics Policy for Board members
- Require Board members to complete annual financial disclosure/conflict of interest statements

### **B. *Audit Committee***

#### 1. Risks

- Risk that there is no Audit Committee
- Risk that Audit Committee members are not adequately trained and qualified to perform their functions and fiduciary responsibilities
- Risk that Audit Committee members are not aware of their fiduciary responsibilities
- Risk that Audit Committee members do not have the independence required to properly perform committee functions
- Risk that Audit Committee members do not have adequate financial literacy
- Risk that the Audit Committee is not adequately involved in selection of external auditor and does not have adequate communications with external auditor during term of the contract
- Risk that Audit Committee does not adequately assess independence of external auditor
- Risk that Audit Committee has inadequate interaction with the internal audit function, including selecting the chief audit executive, approving the internal audit plan, meeting with the Chief Auditor, and reading internal audit reports
- Risk that one or more Audit Committee members may have a conflict of interest

#### 2. Controls to mitigate the risks

- Provide orientation and training for new Audit Committee members
- Provide continuing education and conferences for all Audit Committee members
- Send background/resource information timely to Audit Committee before meetings
- Conduct background checks prior to selecting Audit Committee members
- Develop an Audit Committee charter
- Require Audit Committee members to complete financial disclosure/conflict of interest statement annually
- Ensure that at least one Audit Committee member is a financial and/or benefit expert, such as a Certified Employee Benefit Specialist (CEBS)
- Ensure that external auditors have adequate access to the Audit Committee
- Ensure that internal auditors have adequate access to the Audit Committee

### **C. *Executive***

#### 1. Risks

- Risk that executives do not have management skills to run a public pension plan
- Risk that executives do not have technical knowledge to operate public pension plan
- Risk that executives are engaged in inappropriate activities before being hired and/or during employment, including criminal activity, unethical conduct, and identity theft
- Risk that executives do not perform their fiduciary duties solely for the benefit of members, retirees, and beneficiaries
- Risk that executives do not plan, organize, staff, direct, and monitor the organization

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- Risk that “empire building” occurs
  - Risk that the system gets involved in many inconsequential projects, causing critical functions to suffer
  - Risk that one or more executives may have a conflict of interest
2. Controls to mitigate the risks
- Develop appropriate hiring practices, including job description and minimum qualifications
  - Provide adequate training and education on management functions and responsibilities
  - Provide appropriate technical training
  - Conduct detailed background checks before hiring, including applicant's education, employment history, current or most recent employment, available criminal history, and personal references
  - Adopt a code of conduct
  - Require executives to complete annual financial disclosure/conflict of interest statement that is subject to periodic audit
  - Obtain a copy of executive's Social Security card and run it through various edits
  - Conduct a performance review annually
  - Provide in-house training/presentation to executives on management accountability, separation of duties, and internal controls
  - Ensure that managers perform an annual internal control review, implement appropriate controls to mitigate identified risks, and establish appropriate monitoring/oversight activities
  - Ensure that Audit Committee has appropriate oversight function over executive
  - Ensure that Internal Audit function reports independently/directly to Audit Committee

### ***D. Strategic Planning***

1. Risks
- Risk that pension plan does not have adequate planning and documentation, including a mission statement, strategic plan, implementation plans (one or more years), charters, and policies and procedures for all areas (including the Board, its Committees, Executive, and each program area)
  - Risk that major projects fail or are not completed timely due to inadequate planning
  - Risk that staff resources are not allocated appropriately and efficiently
2. Controls to mitigate the risks
- Develop and monitor organization-wide mission statement, strategic plan, and shorter term plans and goals of one or a few years
  - Appoint a Planning Director whose responsibilities are to develop a mission statement and strategic plan and coordinate the implementation plans
  - Perform an annual risk assessment to identify risks and determine priorities
  - Provide knowledgeable staff at the right times to plan, test, implement, document, and monitor major changes
  - Provide executive oversight team(s) to sponsor, monitor, and prioritize major projects
  - Document procedures on all repetitive processes performed by pension system staff in administering employee benefit programs
  - Hire a person to specifically coordinate written processes among various segments of the organization or include procedure coordination in an existing employee's job description
  - Monitor processes and procedures to ensure compliance with mission statement and strategic plan

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### III. Staffing

#### A. *Attracting, Training, Maintaining, Promoting, and Retaining Employees*

##### 1. Risks

- Risk that pension plan does not offer sufficient salaries, wages, benefits, and working conditions to attract, maintain, promote, and retain high-caliber employees
- Risk that adequate formal and on-the-job training is not provided
- Risk that hired employees do not have the knowledge or expertise for the position
- Risk that employees engaged in inappropriate activities before being hired and/or during employment, including criminal activity, unethical conduct, and identity theft
- Risk that employees are not encouraged to, and provided the opportunity to, acquire skills for higher level positions
- Risk that employees are not encouraged to participate in professional societies and to obtain professional certifications where appropriate

##### 2. Controls to mitigate the risks

- Develop, administer, and/or promote a training plan for all staff
- Provide adequate funding for pension staff training
- Provide adequate training for new employees and periodic training for other employees
- Offer training leading to higher level positions
- Encourage participation in professional societies by paying dues and offering time to attend meetings, serve on society boards, and travel to meetings
- Encourage professional certifications by paying for examination fees and study materials and offering time to prepare for exams
- Encourage maintenance of professional certifications by paying annual dues/fees
- Encourage peer reviews such as in the case of one-person internal audit shops
- Conduct periodic salary/benefit surveys to ensure the system is competitive in the job market (including reviews of the local market and geographic region as well as reviews against the national average and national range [higher and lower wages])
- Provide adequate orientation for new employees, including information on the system's values and code of conduct
- Provide employee handbooks that include job descriptions, organizational charts, compensation and leave policy, and descriptions of benefits
- Conduct annual/periodic employee evaluations
- Conduct thorough background checks on employees being considered for employment or for promotion to a position of trust, especially for those who have high level access authority to member records
- Obtain copies of new employees' Social Security cards and run SSNs through edits

#### B. *Managing Employees*

##### 1. Risks

- Risk that the pension fund managers do not properly manage their employees
- Risk that agency divisions do not function in harmony with each other
- Risk that management and board directives are not communicated to staff
- Risk that staff do not work uniformly and consistently
- Risk that new employees receive insufficient guidance
- Risk that there is no continuity during employee turnover, leave, and/or reassignment

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- Risk that employees have a conflict of interest
- Risk that job functions are not clearly defined and communicated to staff
- Risk that employee evaluations are not timely and/or meaningful
- Risk that staff lack integrity and ethics

### 2. Controls to mitigate the risks

- Ensure careful selection of managers
- Offer management training to new managers and management skills refresher classes for existing managers
- Encourage management meetings to discuss cross-divisional issues
- Encourage communication among all work areas
- Involve staff in major projects to ensure worker perspective
- Hire a person to coordinate cross-divisional communication and solutions to enterprise problems, or train existing managers in these skills
- Develop written procedures for all repetitive processes and update them when needed to: assure management and board directives are communicated to staff; assure staff work uniformly and consistently; train new employees; and provide continuity during employee turnover, leave, and/or reassignment
- Document intra-departmental administrative decisions
- Update written procedures for administrative decisions that impact permanent changes in processing
- Provide clear and current job descriptions for employees
- Prepare and review performance evaluations timely
- Adopt a code of conduct and include it in the employee handbook
- Require employees to sign code of conduct statement annually; follow up non-replies
- Set the tone at the top for a culture of honesty and ethics and clearly communicate acceptable behavior and expectations to staff
- Conduct periodic training for all employees on system's values and code of conduct
- Create a positive workplace environment, including attention to positive feedback, employee recognition, reasonable expectations, and feelings of ownership
- Provide for a telephone hotline or whistle blower contact to encourage employees to report actual or suspected wrongdoing or potential violations of the code of conduct
- Address violations in the system's values and code of conduct immediately
- Establish guidelines and controls regarding outside employment

## **C. *Segregating Duties***

### 1. Risks

- Risk that pension plan does not properly segregate duties among its employees
- Risk that compensating controls do not adequately mitigate risks in areas where segregation of duties is not sufficiently possible
- Risk that segregation of duties is overridden

### 2. Controls to mitigate the risks

- Conduct annual or periodic self-assessment by division managers and staff
- Conduct periodic internal control audits

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### IV. Enrollment of Members

#### A. *Employment and Enrollment of New Members*

##### 1. Risks

- Risk that members are improperly enrolled
- Risk that eligible persons are not enrolled
- Risk that ineligible persons are enrolled
- Risk that ghost employees are enrolled as pension system members
- Risk that employees are enrolled in an incorrect employment category, either intentionally or unintentionally
- Risk that paper documents are not stored securely before being imaged
- Risk that sensitive/confidential documents are not properly safeguarded and disposed of when no longer needed

##### 2. Controls to mitigate the risks

- Provide education or training sessions for employers
- Distribute employer administration manual to all employers
- Provide communications to employers about changes or issues affecting member eligibility
- Provide standardized enrollment forms which require completion of all information necessary to determine eligibility
- Provide on-line, self-editing enrollment where computer feeds back incorrect entries.
- Perform computer matches between enrollment data and payroll data
- Require employers to post employee benefits and pension plan eligibility rules
- Conduct periodic audits of employer payrolls by internal audit staff
- Provide some type of validation of employment status and employment category
- Store documents in fireproof cabinets until imaged
- Develop written policies and procedures for disposal of documents no longer needed (such as storing in locked bins and shredding after a period of time)

#### B. *Communication with New Members*

##### 1. Risks

- Risk that new members do not receive adequate information about the pension plan
- Risk that pension plan counselors are not adequately trained
- Risk that employer benefit specialists are not adequately trained
- Risk that information provided to members is not clear or timely, thereby adversely affecting member decisions

##### 2. Controls to mitigate the risks

- Develop a summary plan description (SPD) that completely, accurately, and clearly describes the significant features of the pension plan (*GFOA recommended practice*)
- Conduct orientation sessions for new employees
- Offer training, materials, and refresher classes for employer benefit specialists
- Provide adequate initial and ongoing training to pension plan counselors
- Send periodic member newsletters
- Include new member information on pension system website
- Require employers to document the transfer of benefit information to each new employee

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### **C. *Benefit Formula***

1. Risk
  - Risk that an incorrect benefit formula is associated with the person
2. Controls to mitigate the risk
  - Establish written procedures and guidelines for staff
  - Include reference to the member's benefit formula in member statements

### **D. *Name***

1. Risk
  - Risk that name on Social Security card is not required on employment records, as required by IRS Publication 15, Circular E
2. Controls to mitigate the risk
  - Require copy of Social Security card for member file or completed IRS Form W-9
  - Use Employee Verification System to identify name discrepancy with SSA
  - Require same name on both SSA and pension plan records

### **E. *Birth Date***

1. Risk
  - Risk that incorrect birth date is received and/or recorded
2. Controls to mitigate the risk
  - Require copy of birth evidence for member file
  - Use Employee Verification System to identify/correct inaccurate date of birth
  - Match electronic data with state vital statistics records, if available
  - Include date of birth on member statements for member verification

### **F. *Marital Status***

1. Risk
  - Risk that incorrect marital status is received and/or recorded
2. Controls to mitigate the risk
  - Require copies of all marriage licenses
  - Require copies of all divorce decrees
  - Require copies of divorce settlements
  - Require awareness of community property provisions in state laws (some states only)

### **G. *Beneficiaries***

1. Risks
  - Risk that correct beneficiaries are not recorded
  - Risk that beneficiary splits are not recorded correctly
2. Controls to mitigate the risks
  - List beneficiaries and split percentages on annual statement of benefits

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### **H. Address**

1. Risks
  - Risk that the correct address is not received and/or recorded
  - Risk that person reporting the change of address is not authenticated
  - Risk that there is no integrated address system to assure addresses are consistent
2. Controls to mitigate the risks
  - Send confirmation letter to member for any address change
  - Follow up timely on mail returned to office as undeliverable
  - Have a procedure for authenticating changes of address (signatures, passwords, voice identification, questions that only the person would know)
  - Implement an integrated address system

### **I. Social Security Number**

1. Risks
  - Risk that incorrect Social Security Number (SSN) is received and/or recorded
  - Risk that IRS fines pension system for using incorrect SSN
2. Controls to mitigate the risks
  - Require copy of Social Security card for member file or completed IRS Form W-9
  - Use SSA's Employee Verification System to identify/correct inaccurate SSN
  - Verify keyed SSNs by techniques such as duplicate keying

### **J. Gender**

1. Risk
  - Risk that incorrect gender is entered into the system, affecting actuarial calculations
2. Controls to mitigate the risk
  - Use Employee Verification System to identify/correct inaccurate sex code

## **V. Collection and Maintenance of Member Data**

### **A. Payroll Data**

(See also sections XIII.C. and D. and XVII.)

#### 1. Risks

##### Compensation and Contributions

- Risk that incorrect compensation/contributions data is received and/or recorded
- Risk that reported compensation includes overtime, per diem, etc., that is not allowed
- Risk that retroactive payments are not handled correctly
- Risk that contributions received are not credited to the correct accounts

##### Timeliness

- Risk that payroll data is not received timely or at all
- Risk that pension system staff does not follow up on contributions not received
- Risk that payroll data is not recorded promptly into the member database, resulting in erroneous benefit calculations which must be updated

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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### Service Credit

- Risk that incorrect service credit data is received and/or recorded

### Tax-Deferred Contributions

- Risk that employer incorrectly reports tax deferred contributions as regular taxable contributions or reports regular taxable contributions as tax deferred contributions
- Risk that employer does not notify pension system of changes to tax deferred contributions in a timely manner
- Risk that tax deferred contributions are not included as salary for retirement purposes

### 2. Controls to mitigate the risks

- Conduct audits of individual employers
- Provide employer training and/or visits
- Develop/distribute employer administration manuals that include examples of reportable and non-reportable earnings, examples of differences between reporting criteria for retirement system and other governmental agencies such as IRS and SSA, and information on the importance of documenting decisions involving earnings
- Send periodic employer newsletters and bulletins
- Promulgate administrative rules to clarify statutory provisions for reportable earnings
- Develop a website for employer information and questions
- Create a system that receives data promptly and records information into each member's account promptly
- Include transaction documentation/audit trail in participant files for each monetary adjustment
- Reconcile cash receipts to employer payroll reports received
- Match contribution rates paid with contribution rates required by actuaries
- Send quarterly statements to employers listing employer and member contributions received by the plan, and employer beginning and ending account balances so that employers can reconcile their books to pension system books
- Create an Employer Self Audit that allows employers to check their own data
- Maintain a list of anticipated employer payroll reports and check them off as received
- Follow up on payroll reports not received
- Implement statutes and/or rules that penalize employers for submitting reports late

## **B. Changes to Member/Retiree Data**

### 1. Risks

#### Indicative Data

- Risk that incorrect and/or unauthorized changes are made to name, address, SSN, date of birth, and other indicative data
- Risk that members do not give timely notification of change
- Risk that data is inconsistent between stand-alone Systems or among data components of integrated Systems
- Risk that paper documents are not stored securely before being imaged
- Risk that sensitive/confidential documents are not properly safeguarded and disposed of when no longer needed

#### Employment/Employer

- Risk that changes in employment are not received and/or recorded

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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### Service Credit/ Portability/Reciprocity/Transfers

- Risk that portability/reciprocity data is not received and/or entered properly
- Risk that purchase of prior service is incorrectly allowed or incorrectly rejected
- Risk that prior service credit is incorrectly calculated
- Risk that cost of, and payments for, prior service credit are incorrectly calculated
- Risk that prior service credit is incorrectly recorded in the system
- Risk that a member's service credit balance is inappropriately adjusted or altered
- Risk that retirement plan contribution transfers are accepted from non-qualified plans
- Risk that receivables for buy-backs/transfers are not properly established
- Risk that checks/payments for buy-backs/rollovers are not properly safeguarded, transferred, cashed, and credited to the correct member account
- Risk that accounts receivable delinquencies are not followed up

### Marital Status/Divorce/Community Property

- Risk that changes in marital status, divorce court settlements, and community property agreements are not received and/or recorded properly and timely

### Beneficiaries

- Risk that changes in beneficiaries are not received and/or recorded timely or properly
- Risk that unauthorized changes are made to beneficiary information for purpose of fraud

### Child Support

- Risk that child support orders are not received and/or recorded properly and timely

### Security of Change Process

- Risk that unauthorized changes are made to member data
- Risk that employees who are members have improper access to their own files/data

## 2. Controls to mitigate the risks

- Develop procedures for authenticating source(s) of changes in member data when changes are received on paper or online, including but not limited to, comparison of signatures, passwords, and digital signatures
- Use Employee Verification System to identify/correct inaccurate indicative data
- Send confirmation letters to member when beneficiaries are changed
- Have an automated system to track any changes to a member's record and identify the date and user making the change
- Monitor member records for unusual items or changes
- Allow system access only for staff needing access for their jobs
- Send annual statements with request to members to notify system if data is incorrect
- Establish a post-processing reconciliation review of all participant account information
- Include transaction documentation in participant files for each service adjustment to provide an audit trail
- Develop written procedures to ensure compliance with relevant statutes and ensure consistent/accurate processing and performance standards
- Publish a brochure such as *How Divorce Can Affect Your Benefits*, and emphasize the importance of having a current beneficiary designation on file
- Send a new beneficiary designation form to members and annuitants after receipt of documentation and/or court orders indicating divorce
- Develop a process for sampling and testing file maintenance transactions regularly

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Reconcile data between stand-alone systems
- Use automated validation techniques to reconcile data components of integrated Systems
- Follow up account receivables periodically
- Store documents in fireproof cabinets until imaged
- Develop written policies and procedures for disposal of documents no longer needed (such as storing in locked bins and shredding after a period of time)

### **C. Maintenance of Member/Retiree Data**

#### 1. Risks

##### Integrity of Data

- Risk that data is not maintained and backed up properly to maintain data integrity

##### Security of Data

- Risk that database is not secure from both internal and external threats, compromising data confidentiality
- Risk that the pension system has not established a procedure for guarding sensitive information and reducing the potential for identity theft
- Risk that paper files/records are not secure from fire or other natural disasters
- Risk that member records are used unethically or illegally by pension system staff
- Risk that electronic data is lost because of system outages/downs

##### Accuracy of Data

- Risk that data is not accurate
- Risk that data exceptions/errors are not identified and/or corrected on a timely basis

##### Completeness/Accessibility of Member Files

- Risk that member files (paper) are not complete
- Risk that member files (imaged) are not complete and are not properly backed up
- Risk that member imaged files cannot be accessed timely when the system is down

#### 2. Controls to mitigate the risks

- Ensure physical security of the premises and of the information system components
- Ensure logical security for the information system components
- Conduct security awareness training for employees
- Change user identification and passwords periodically, such as every 60-90 days
- Back up data daily
- Develop written policies and procedures, including written procedures to monitor compliance for daily back-up of data
- Store data in fireproof file cabinets until it is recorded permanently
- Review confidentiality policy of employees on annual basis and update as necessary
- Review system accessibility by all staff members periodically and allow system access only for staff needing access for their jobs
- Use Employee Verification System to identify/correct inaccurate data
- Send annual statement of account to members with dollar amounts, SSN, date of birth, beneficiary, etc. so that member has opportunity to identify data errors
- Use system generated identification number rather than SSN on correspondence to reduce potential for identify theft

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Develop a business continuity/contingency plan and tests of the plan, including a back-up business resumption site
- Establish information technology (IT) security controls, including monitoring home access (dial-up) and monitoring what files are accessed
- Allow sufficient time to correct identified problems and locate forms before destroying records for a new imaging system
- Microfilm critical records and store microfilm off-site
- Develop statutes for state-wide criteria for retention of electronic/paper records; develop pension system written administrative policies, criteria, and procedures for record retention

## VI. Communications with Members

### A. *Member Statements*

1. Risks
  - Risk that member statements are inaccurate and/or incomplete
  - Risk that members do not receive statements
  - Risk that someone other than the member receives the statement
2. Controls to mitigate the risks
  - Perform a quality control check for a sample of statements
  - Provide a way for members to correct inaccurate information via mail, telephone, or website after proper authentication of each member
  - Use an abbreviated rather than the full SSN on the statement
  - Use the United States Postal Service Annual Address Match
  - Use an online service to locate lost contacts

### B. *Retirement Estimates*

1. Risks
  - Risk that estimates are provided to a member before service credit history has been recorded and/or audited
  - Risk that retirement estimates are not accurate because of incorrect and/or incomplete information:
    - Benefit formula
    - Option
    - Employment category
    - Service credit
    - Final compensation
    - Age at retirement
2. Controls to mitigate the risks
  - Periodically test the system with data for which the outcome is known
  - Provide quality assurance review of calculated estimates
  - Create a system that receives data promptly and records information into the member database promptly (See section V.A.)

### C. *Retirement Planning Services*

1. Risks
  - Risk that members do not receive adequate retirement planning services

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Risk that retirement alternatives are not adequately presented to potential retirees
  - Risk that staff providing services are not well trained and provide incorrect information to potential retirees
2. Controls to mitigate the risks
- Provide periodic financial education and retirement planning sessions throughout the employees' careers (*GFOA recommended practice*)
  - Offer pre-retirement planning sessions at least 5 years prior to projected retirement age (*GFOA recommended practice*)
  - Provide well designed, ongoing training program for retirement staff
  - Provide well designed, up-to-date, and easily understood information on the website (see later controls under "Internet Access to Information")

### **D. Customer Service**

1. Risks
- Risk that various forms/methods of communication with members, retirees, and beneficiaries are not coordinated and consistent (i.e., literature, internet, telephone, and field offices)
  - Risk that system communication, processes, and policies are not customer oriented
  - Risk that appeals occur because of inadequate communication among members, employers, the pension system, and third party administrators
2. Controls to mitigate the risks
- Hire an Information/Communication Coordinator for the pension system
  - Hire a Manager of Quality Assurance and form a Quality Assurance Committee
  - Develop an ongoing quality assurance process involving closed appeals and a continuous review of possible improvements in customer service, policies, processes, forms, and communications
  - Participate in a study and measurement of performance and cost effectiveness in order to learn how comparable pension systems perform; develop new service standards; identify best practices; monitor performance; identify priorities; identify areas needing improvement; better understand the system; improve the decision-making process; and implement changes to improve the quality of customer service

### **E. Publications**

1. Risks
- Risk that literature available to members is incomplete/inaccurate
  - Risk that newsletters and special mailings are unclear
  - Risk that standard publications are not consistently used to provide accurate information to large groups
  - Risk that information in publications does not agree with statutes, rules, or contract
  - Risk that forms cannot be kept up-to-date and inventoried because of the volume
2. Controls to mitigate the risks
- Have appropriate staff and/or the legal office review and sign off on new/revised forms
  - Enlist the assistance of annuitants and/or external employees to review important mailings before they are sent
  - Hire a forms coordinator to coordinate forms for the pension system

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Include appropriate language on publications such as: "*Every effort has been made to ensure that the information in this publication is accurate. If the information should conflict with the law, rules, contract, or plan language, then the law, rules, contract or plan language must take precedence.*"
- Review the summary plan description (SPD) periodically to keep it current (*GFOA recommended practice*)

### **F. Internet Access to Information**

#### 1. Risks

- Risk that information made available on the Internet does not agree with statutes, rules, or contracts
- Risk that information on the Internet is incomplete/inaccurate
- Risk that access to individual's private information is not secure
- Risk that customers are not authenticated prior to accessing confidential information or providing confidential information

#### 2. Controls to mitigate the risks

- Develop procedures for appropriate staff and/or the legal office to validate/review information prior to placement on the website (review and sign-off)
- Have qualified staff check existing information on the website periodically
- Maintain physical security and logical security of website and data
- Authenticate users (for example, require pin numbers to access member account via the internet)
- Provide appropriate education and training to staff working on website
- Assign one or more individuals responsibility for maintaining the website timely
- Include appropriate language on the website such as: "*Every effort has been made to ensure that the information on this website is accurate. If the information should conflict with the law, rules, contract, or plan language, then the law, rules, contract or plan language must take precedence.*"

### **G. Customer Call Center**

#### 1. Risks

- Risk that information made available does not agree with statutes, rules or contracts
- Risk that information given by call center is incomplete/inaccurate
- Risk that call center employees are not adequately trained
- Risk that callers are not authenticated and confidential information is given or customer information is accepted
- Risk that system problems prevent call center staff from providing information timely or accurately
- Risk that call center staff do not provide information timely

#### 2. Controls to mitigate the risks

- Have appropriate staff and/or the legal office review information made available
- Provide ongoing training and supervision to call center employees, using approved information
- Use training manual to train call center employees
- Update other resources, such as keyword searchable database of frequently asked questions (FAQs), to answer callers' questions consistently and accurately

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Use experienced staff as resources and mentors
- Authenticate caller identity at the beginning of each call. Establish standardized questions to identify member before releasing or accepting confidential information
- Record calls to use as training tools and to identify problem issues, using established benchmarks
- Install and maintain the telephone system properly
- Establish a service level objective to answer calls within a certain period of time

### ***H. Field Offices/Field Presentations***

#### 1. Risks

- Risk that information does not agree with statutes, rules, or contracts
- Risk that information is inaccurate and/or incomplete
- Risk that field offices/presentations are not easily accessible to members, retirees, and beneficiaries
- Risk that field staff do not receive adequate formal and on-the-job training
- Risk that customers are not authenticated before confidential information is given or customer information is accepted

#### 2. Controls to mitigate the risks

- Have appropriate staff and/or the legal office review/sign off on available information
- Set up temporary offices through the region (e.g., rent space in a building or strip mall for a month or set-up a trailer in a parking lot for a few weeks)
- Conduct employee benefit presentations regularly throughout the state
- Provide adequate initial and ongoing training for field office staff
- Authenticate customers at the beginning of the session

### ***I. Unclaimed Member Accounts and Unclaimed Benefits***

#### 1. Risks

- Risk that pension system does not comply with IRS minimum distribution requirements
- Risk that inactive members who are deceased are not identified
- Risk that system does not effectively pursue contact with lost retirees and/or beneficiaries
- Risk that pension system does not adequately search for inactive members
- Risk that pension system does not provide a mechanism whereby inactive members or heirs of inactive members/annuitants can search for unclaimed benefits
- Risk that pension system staff divert unclaimed funds for their own personal use
- Risk that someone steals member's identity and fraudulently claims the account
- Risk that poor public perception results when locator services independently find published lost contact members and charge members a high percentage fee

#### 2. Controls to mitigate the risks

- Identify inactive records with a special code
- Audit inactive accounts for compliance with IRS minimum distribution requirements
- Use on-line search services, locator services, National Change of Address Service, and Social Security Administration letter forwarding services to locate lost members
- Match data with files maintained by other federal/state agencies/divisions such as Office of Vital Records, Division of Motor Vehicles, Department of Revenue, State Treasurer, Division of Unemployment Compensation, and Internal Revenue Service to identify/correct inaccurate data

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Contact former employers for addresses of inactive/terminated members
- Publish annually a list of unclaimed accounts and/or benefits in the official state newspaper and pension fund newsletter
- List lost members and retirees on internet site
- Use Employee Verification System to identify/correct inaccurate data, thus improving capability of locating member, identifying a death, or making automatic distributions timely
- Attempt to contact inactive employees prior to the year in which IRS requires distribution
- Use SSA Death Master File to identify deceased inactive participants
- Require addresses from all employees at termination
- Stratify inactive member balances so higher risk (dollar) accounts receive priority
- Send annual Statement of Account or newsletter to inactive members
- Follow up timely Statements of Account that are returned as undeliverable
- Ensure that state statutes provide criteria for identifying lost contacts, publishing names, and writing off or paying amounts
- Develop additional controls such as supervisory reviews and required birth evidence when paying benefits on accounts that have been inactive for a period of time

### VII. All Benefits

#### 1. Risks

- Risk that benefit amount is incorrectly calculated because of:
  - ✓ incomplete/inaccurate data, service credit, and/or final compensation
  - ✓ incorrect benefit formula
  - ✓ system errors
  - ✓ human errors
  - ✓ incorrect birth date (age at retirement)
  - ✓ incorrect leave balance (i.e., accrued vacation or sick leave)
  - ✓ benefit changes over time that must be manually calculated
- Risk that benefits are paid to unauthorized persons
- Risk that inactive claimants are not properly authenticated before payment is made
- Risk that benefit is fictitious or not authorized
- Risk that benefits are paid to deceased persons
- Risk that mortality tables are not updated when appropriate (See section XII.A.1.)
- Risk that benefit calculation errors are not discovered
- Risk that underpayments due members/retirees are not subsequently paid
- Risk that overpayments to retirees/beneficiaries are not subsequently collected per applicable statutes
- Risk that benefits are not paid timely
- Risk that paper checks are lost or not received timely
- Risk that payments are not in compliance with IRS regulations for automatic distributions
- Risk that unauthorized benefit payments are calculated and paid
- Risk that duplicate payments are made— automated and manual systems
- Risk that unclaimed benefits are not properly recorded, accounted for, & safeguarded
- Risk that stale dated checks are not followed up
- Risk that stale dated checks are automatically reissued without follow-up, resulting in payments to incompetent or deceased persons
- Risk that stale dated checks are automatically reissued without adequate segregation of duties, resulting in diversion of checks by pension system staff for their own use
- Risk that an employee is allowed to work on calculations of a relative or friend

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Risk that employees intentionally alter a claim in the computer system, resulting in overpaid benefits
  - Risk that exceptions are not identified and followed up
  - Risk that federal/state tax withholding amounts are incorrect or are not adjusted as conditions change
  - Risk that incorrect SSN is sent to federal/state tax authorities
  - Risk that benefit enhancements are not provided timely or accurately
  - Risk that overpayments are not accounted for and collection efforts not put into place
  - Risk that identity theft results in fraudulent payments
  - Risk that inappropriate deductions are taken from benefit payments (for example, dissolution orders, wage assignments, and elective deductions such as savings bonds or credit unions)
2. Controls to mitigate the risks
- Develop written policies and procedures to assure that benefits are processed accurately, uniformly, and timely in compliance with state statutory provisions, administrative rules, IRS requirements, and management directives
  - Create an on-line desk manual
  - Document processes for any special rules that may apply to manual calculations
  - Provide retiree with summary of data used in benefit calculation, including benefit formula, service credit, highest/average compensation, age, gender, calculation(s)
  - Provide adequate segregation of duties among staff processing benefits, including re-issuing stale-dated checks
  - Authenticate person requesting a benefit
  - Require notarized signatures on applications from persons who have been inactive for a period of time
  - Require additional documentation (such as SSN card or birth certificate, if not already on file) from members who have been inactive for a specific period of time
  - Require supervisory reviews of benefits paid on accounts that have been inactive for a specific period of time
  - Conduct death matches for annuitants/non-annuitants using Social Security Administration Death Master Death File/updates, state Vital Records, and/or outside vendors
  - Send confirmation letters to persons who are listed as deceased on death match reports and require a (notarized) signature before making payment to applicants or continuing monthly benefits to annuitants
  - Record dates of death on member records as soon as known
  - Use SSA's Employee Verification System to identify/correct inaccurate SSNs, names, and dates of birth, thus improving the accuracy of death matches, benefit calculations, and benefit payments
  - Require copy of birth evidence and Social Security card for member's file
  - Generate exception reports and conduct regular supervisory reviews of them
  - Establish performance standards for timeliness and accuracy
  - Require/encourage electronic payments to banks
  - Develop charts and/or checklists to aid staff in determining benefits payable
  - Update mortality tables periodically (for example, every 5 years)—See Actuary XII.A.,2
  - Test automated benefit calculations adequately
  - Send annual statement of benefits to inactive members
  - Notify inactive members of minimum distribution requirements prior to the year in which IRS requires distribution

# **PUBLIC PENSION SYSTEMS**

## **Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks**

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- Use restricted delivery for certified letters when sending benefit information about Internal Revenue Service minimum distribution requirements to inactive members
- Publish annual article in system newsletter, emphasizing the tax penalty and the importance of complying with IRS minimum distribution requirements
- Develop written procedures for following up uncashed checks
- Verify that payee is alive before reissuing a stale-dated check
- Utilize computed assisted audit techniques (CAAT) to test benefit calculations
- Develop a well controlled account receivable process
- Use a collection agency to recover overpayments that are difficult to collect
- Publicize litigation against those who fraudulently received benefits
- Conduct identity theft training for applicable staff
- Examine transit routing and account numbers periodically where multiple checks are being electronically routed
- Verify that inactive member is living before contacting and/or making automatic distributions
- Use automated edits/matches to identify invalid/incorrect SSNs for pending payments
- Use a separate post office box and independent pick-up for checks returned as undeliverable or establish a central place for receipt of returned checks
- Reconcile benefits processed/paid with statistics for various work areas
- Print following language on checks: "void if payee died prior to check date"
- Reconcile employee and employer accounts on a monthly basis or oftener
- Perform analytical audits and make year by year comparisons of member account values to detect aberrant changes between years

### **VIII. Withdrawals/Refunds**

#### 1. Risks

- Risk that refund is made to the wrong person
- Risk that an incorrect amount is paid
- Risk that a transferee from one agency to another receives a refund in error
- Risk that payee cannot be located if supplemental benefit is to be paid
- Risk that taxes are not withheld if contributions are not rolled over to qualified plan
- Risk that records are not retained long enough after payment and data is needed if person enrolls again

#### 2. Controls to mitigate the risks

- Authenticate persons requesting refunds
- Maintain up-to-date and accurate member records (See section V)
- Inform members of withholding requirements if money is not transferred to qualified plan through the brochures, Internet, on the telephone, and at the time of the request to withdraw the member contributions
- Retain records for extended period of time based upon state law and life expectancy

### **IX. Disability Retirement Benefits and Estimates**

#### 1. Risks

- Risk that a person is not truly disabled under the provisions of law/contract
- Risk that physicians are paid for services they did not perform or are paid twice for the same services

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Risk that system has no checks/balances on effectiveness of physicians who evaluate applicants/recipients
  - Risk that physicians performing medical exams are not qualified
  - Risk that access to confidential medical information is not restricted as required by law
  - Risk that disability applications are not reviewed for statutory timing constraints
  - Risk that application is not processed within a reasonable period of time
  - Risk that continuing eligibility is not verified
  - Risk that benefit is not stopped once the Board determines individual is not disabled
  - Risk that benefit is not offset for applicable income or is not offset timely
  - Risk that allowable earnings are not independently verified when disability recipient is gainfully employed (in Systems with allowable earnings limitations)
  - Risk that disability recipients who have reached the age for regular retirement (and are eligible) continue to undergo verification medical exams at a cost to the system (in Systems that require verification medical exams)
  - Risk that denied applicants are not advised of their right to appeal
  - Risk that deductions for insurance premiums are incorrect or not adjusted when necessary
2. Controls to mitigate the risks
- Require initial medical exams by at least two physicians, one of whom is selected by the pension system
  - Restrict access to medical records only to staff needing access to perform their jobs
  - Protect medical information once it has been accessed by staff
  - Promulgate administrative rules to establish timelines for submission of application, employer certification, medical evidence, and other required documentation
  - Develop written procedures and checklists to assure that applications are processed uniformly, completely, and timely
  - Require annual signed statements, verifying continued eligibility
  - Establish good communication with the Board to ensure proper notification of disability approvals, denials, and revocations
  - Establish investigations unit to perform *sub rosa* (secret) investigations to locate documents and witnesses and work with independent medical examiners
  - Contract with outside vendor to provide proof of disability ineligibility, if necessary
  - Require periodic annual medical evaluations after the disability annuity has been approved (in selected cases warranting periodic reviews)
  - Develop statutes which define the earnings limitation for disability annuitants and provide for automatic indexing
  - Monitor other income continuously
  - Require copies of annual tax returns to verify earnings of disability annuitants
  - Match pension records with state tax return data
  - Develop an automated edit to identify disability recipients who attain the normal retirement age and no longer need to undergo verification medical exams
  - Develop written procedures and standardized letters to inform denied applicants of their right to appeal

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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### X. Retirement Benefits

#### A. *Defined Benefit Programs (ordinary)*

##### 1. Risks

- Risk that annuity is based on incorrect service credit, highest compensation, benefit formula, and/or age
- Risk that payment for unused leave is converted to service credits in error
- Risk that annuity is not recalculated after additional earnings and service are reported
- Risk that annuity is based on named survivor's incorrect date of birth
- Risk that annuity adjustments are incorrect
- Risk that incorrect benefit changes are made for COLA, benefit enhancement, and other reasons
- Risk that unauthorized changes are made to retirement benefit payrolls within the pension plan, during transport, or at the site where checks/electronic fund transfers are generated
- Risk that deductions for insurance premiums and federal/state tax withholding are not processed correctly or are not adjusted when necessary
- Risk that appropriate annuity adjustments are not made upon death of annuitant/named survivor
- Risk that annuity is not terminated timely upon expiration of the guarantee period
- Risk that checks returned to the system are not followed up
- Risk that annuity was terminated in error because of inaccurate report of death
- Risk that suspended annuity is not resumed after contact has been made with lost retiree
- Risk that initial or corrected information reported to federal/state tax authorities is not accurate, causing penalties for the system and over/under tax payments for retirees
- Risk that annual tax information is not sent timely to federal/state tax authorities
- Risk that retiree will work for a covered employer without being reported, resulting in overpaid benefits
- Risk that military or other allowable service is not correctly determined

##### 2. Controls to mitigate the risks (see section V., Collection and Maintenance of Member Data)

- Ensure that correct information is obtained from the member database
- Send a notice of benefits to the annuitant that discloses data used and calculations made in arriving at the amount of the annuity
- Perform deaths matches using Social Security Administration Death Master Death File/ updates, state Vital Records, and/or outside vendors
- Require copy of named survivor's SSN and birth evidence at time annuity begins
- Send annual reminders to annuitants to report address changes
- Use Employee Verification System to identify/correct inaccurate data for named survivor
- Conduct independent account integrity reviews such as comparing amounts and other data changes between years
- Grant access authority to staff only for those programs and specific account information needed to perform their duties
- Require the Security Officer to monitor access security
- Review suspended annuities periodically
- Use addresses that meet U.S. Postal Service addressing standards
- Adjust federal/state tax withholding automatically when annuity amount changes
- Perform edits to assure that all annuities have an expiration date
- Automate processes to eliminate/reduce manual calculations

# PUBLIC PENSION SYSTEMS

## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Inquire at retirement counseling session whether person has military service
- Obtain copies of military records

### ***B. Lump Sum Option Plans (LSOP): Forward and Back Deferred Retirement Option Programs (Forward DROP and Back DROP) and Partial Lump Sum Option Plan (PLOP)***

#### 1. Risks

- Risk that LSOP plan is not being administered in compliance with state law, rule, or regulation
- Risk that LSOP account is improperly maintained
- Risk that proper tax withholding is not taken if LSOP account is withdrawn and not rolled over to a qualified plan/IRA
- Risk that participants are still contributing/earning service credit while in LSOP
- Risk that contributions are not resumed when LSOP ends and employee continues to work
- Risk that LSOP program is not accounted for properly in the audited financial statements

#### 2. Controls to mitigate the risks

- Create a charter that includes objectives and responsibilities of the LSOP program
- Create procedures for handling creation, maintenance, and termination of LSOP accounts
- Provide initial and continuing training to employees working in the LSOP program
- Provide proper internal controls and adequate accounting for the LSOP program
- Provide proper financial accounting for LSOP programs. Determine whether LSOP program transfers defined benefit payments into a defined contribution plan, so that LSOP is a defined contribution plan for financial accounting and reporting purposes

## **XI. Deaths/Survivor Benefits**

#### 1. Risks

- Risk that death of retiree is not received/recorded promptly, resulting in overpayments
- Risk that benefits are not stopped as soon as death is confirmed
- Risk that deaths of annuitants living outside the U.S. are not identified
- Risk that death is not identified because system has incorrect SSN
- Risk that living person is reported as deceased, thus terminating annuity in error
- Risk that independent source is not used to verify accuracy of death data
- Risk that death benefits are issued prior to the return of outstanding overpayments
- Risk that annuity overpayments are not identified, recorded, and collected
- Risk that decedent account has accumulated significant over/underpayments
- Risk that some or all beneficiaries cannot be located
- Risk that annuity is not reduced/adjusted, if applicable, when continuing to beneficiary
- Risk that benefits are paid to surviving spouse, ex-spouse, other beneficiaries, or estate not entitled to the benefits
- Risk that unclaimed benefits are paid out to unauthorized individuals
- Risk that survivor benefits continue in error after the annuity expiration date or to persons no longer eligible
- Risk that benefit is not divided correctly between spouse and children
- Risk that benefits to minors are not monitored/terminated upon their reaching age of majority
- Risk that system does not verify students are enrolled in school full-time, if required

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## Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks

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- Risk that pension system does not comply with IRS minimum distribution requirements to beneficiaries
  - Risk that incorrect death benefit is paid (active vs. inactive) to survivor
2. Controls to mitigate the risks
- Perform death matches with Social Security Administration and State Vital Records
  - Hire outside vendors to conduct death matches
  - Search Internet periodically for online death notices
  - Utilize newspaper/ periodical clipping service in area, if available, to identify deaths
  - Send annual reminders (statements, newsletters, correspondence) to members and beneficiaries, requesting they report deaths, address changes, and beneficiary changes
  - Identify annuitants living outside the U.S. with a special code on the annuity system and send annual confirmation letters to them
  - Use Employee Verification System to identify incorrect SSNs
  - Require death certificates for member files
  - Verify SSA reported deaths before terminating annuities (includes telephone calls, certified letters, and other means)
  - Verify eligibility for continued payments by annual certification forms signed by spouses and children
  - Compile a list of beneficiaries who do not receive benefits when first eligible and send annual letters to them
  - Validate carefully the employment history to identify dates of service that are consistent with death benefit payment type

## **XII. Actuary**

### **A. Assumptions**

1. Risks
- Risk that actuarial assumptions are not realistic
  - Risk that actuarial assumptions are made on erroneous/inaccurate data
  - Risk that political pressure is exerted to modify assumptions that do not reflect reality
  - Risk that mortality tables are not updated as appropriate
2. Controls to mitigate the risks
- Discuss actuarial assumptions at Board meetings
  - Require that knowledgeable staff review actuarial report
  - Have an actuarial valuation prepared at least biennially by a qualified actuary in accordance with the principles and procedures established by the Actuarial Standards Board (ASB), based on a discussion with the actuary of funding methods and assumptions (*GFOA recommended practice*)
  - Hire an independent actuarial firm at least every five years to audit actuarial assumptions
  - Implement entry/exit analysis to review trends and data changes from year to year
  - Update mortality tables periodically (for example, every 5 years)

### **B. Assets/Liabilities**

1. Risk
- Risk that actuarial assets and liabilities are not matched (asset-liability study)
2. Controls to mitigate the risk

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- Establish a period for amortization of unfunded actuarial accrued liabilities that conforms with the parameters established by GASB (*GFOA recommended practice*)
- Assure that actuarially required contributions are collected timely and not postponed or reduced (*GFOA recommended practice*)
- Have an actuarial experience study performed at least once every five years (*GFOA recommended practice*)
- Assign in-house staff with actuarial knowledge to review work of outside actuary
- Hire an independent actuarial firm preferably every two years, or at a minimum of once every five years, to perform an audit of the actuarial valuations (*GFOA recommended practice is at least once every 10 years*)
- Implement entry/exit analysis to review trends and data changes from year to year

### **C. Actuarial Computer Program (Algorithm)**

#### 1. Risks

- Risk that actuarial computer program (algorithm) is incorrect
- Risk that actuarial models have not been properly updated to reflect changes in benefit formulas
- Risk that actuarial models do not conform to, or are not updated for, applicable laws, and/or changes in the laws
- Risk that actuarial reduction factors for those retiring before normal retirement age are not accurate
- Risk that programming does not correctly analyze data

#### 2. Controls to mitigate the risks

- Hire an independent actuarial firm at a minimum of once every five years to perform audit of the actuarial valuation that includes a parallel calculation of actuarial liabilities
- Develop a quality assurance program for Information Technology (IT) and operations staff to validate that the data was correct and analyses accurate

### **D. Data**

#### 1. Risks

- Risk that data transmitted to the actuary is incomplete/erroneous
- Risk that contribution data used is based upon payroll data rather than cash received
- Risk that data exceptions or errors noted by the actuary are not researched/corrected timely
- Risk that programming does not correctly analyze data

#### 2. Controls to mitigate the risks

- Develop reasonableness checks that identify possible data errors
- Conduct data audits
- Develop controls to determine reliability of data received, data input, and data maintenance
- Require that contributions are based solely upon cash received
- Require that exceptions and errors be researched and corrected
- Use computer assisted audit techniques to evaluate data and identify change anomalies from year to year
- Develop quality assurance of programming by Information Technology (IT) and operations staff to validate data was correct and analyses accurate
- Implement entry/exit analysis to review trends and data changes from year to year

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### ***E. Employer Contribution Rates***

1. Risk
  - Risk that employer contribution rates are not accurate due to program or data errors
2. Controls to mitigate the risk
  - Require annual presentations by the actuary to the Board, including discussions of employer contribution rates and specific changes to rates
  - Hire an independent actuarial firm at a minimum of once every five years to perform audit of the actuarial valuation that includes a parallel calculation of contribution rates

### ***F. Second Opinion***

1. Risk
  - Risks that problems are not identified because a complete second actuarial determination is not performed periodically
2. Controls to mitigate the risk
  - Hire an independent actuarial firm at a minimum of once every five years to perform audit of the actuarial valuation that includes a parallel calculation of actuarial liabilities

### ***G. Employer Contract Changes—Costs of Providing Estimates of Potential Changes to the Benefit Structure***

1. Risks
  - Risk that employers/employee groups are overcharged or undercharged for the cost to produce an estimate of the effects of changing benefits or other employer contract provisions, resulting in a monetary subsidy or loss to the groups using the service
  - Risk that employers/employee groups are undercharged for the cost to produce an estimate of the effects of changing employer contract provisions, resulting in numerous requests to the actuaries so that excessive resources are diverted to these services
2. Controls to mitigate the risks
  - Develop a cost accounting data system to determine the cost of estimates and charge employers these amounts

## **XIII. Communication with Employers**

### ***A. Employer Responsibilities***

1. Risk
  - Risk that employer staff are not adequately trained for their responsibilities
2. Controls to mitigate the risk
  - Provide training for new staff responsible for pension system reporting, etc.
  - Perform quality assurance reviews of data/information
  - Perform random and non-random (*i.e.* selected) audits of data/information
  - Provide Employer Manual that includes periodic updates that are clear and accurate

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### ***B. Member Services***

#### 1. Risks

- Risk that employer benefit specialists are not given adequate information and training to communicate pension plan provisions to employees
- Risk that inadequate information is transmitted to the employers on benefit plans and services available (i.e., brochures, Internet access, telephone services, and walk-in opportunities)

#### 2. Controls to mitigate the risks

- See section VI, Communication with Members
- Provide information and ongoing training to all employer benefit specialists
- Provide high quality brochures, internet information, telephone service, and customer service representatives

### ***C. Contribution Rates***

#### 1. Risks

- Risk that employers are not given adequate notice of anticipated changes in employer contribution rates, and reasonable estimates of the magnitude of changes
- Risk that pension staff does not notify employers timely of changes in employee and employer contribution rates once the new rates are calculated
- Risk that employers are not given adequate reasons for changes in employer contribution rates
- Risk that employer does not update programs for contribution rate changes, resulting in inaccurate contributions
- Risk of communication interpretation errors between Investment staff and other pension system staff regarding earnings or losses, resulting in pension system staff providing incorrect rates to employers
- Risk that employer contribution rates are not sufficient to fund benefits

#### 2. Controls to mitigate the risks

- Perform evaluations and inform the employer promptly of changes in employer contribution rates; provide explanation of the changes
- Input data quickly from employers into contributions accounting system(s)
- Validate contributions independently to assure rates are accurate
- Match contribution rates paid with contribution rates required by the actuary
- Perform supervisory reviews and reasonableness checks to identify obvious errors
- Perform employer payroll audits
- Hire an independent actuarial firm at a minimum of once every five years to perform an audit of the actuarial valuation that includes a parallel calculation of actuarial liabilities (See section XII, Actuary)

### ***D. Contributions***

(See also sections V.A. and XVII.)

#### 1. Risks

- Risk that contributions are not correct because of wrong contribution rates, incorrect data, and/or incorrect calculations
- Risk that contributions received are not credited to the correct accounts

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- Risk that employer and member contributions are not received timely or at all
  - Risk that pension system staff does not follow up on contributions not received
  - Risk that pension system applies incorrect interest rates when collecting contributions from different fiscal/calendar years
  - Risk that employers do not notify retirement system of changes in employee contributions (such as employer pick up or tax deferred contributions) or do not comply with policies governing these changes
  - Risk that pension staff does not update system when notified of changes in employee contributions (such as employer pick up or tax deferred contributions)
  - Risk that employer does not update programs for contribution changes, thus submitting inaccurate information
2. Controls to mitigate the risks
- Reconcile cash receipts to employer payroll reports received
  - Send quarterly statements to employers listing employer and member contributions received by plan, and employer beginning and ending account balances so that employers can reconcile their books to pension system books
  - Match contribution rates paid with contribution rates required by actuaries
  - Perform employer payroll audits
  - Create a system that receives data promptly and records information into each member's account promptly
  - Maintain list of anticipated employer payroll reports and check them off as received
  - Follow up on employer payroll reports not received
  - Perform supervisory reviews and reasonableness checks to identify obvious errors
  - Implement statutes and/or rules that penalize employers for submitting reports late

### ***E. Employer Contract Amendments***

1. Risk
- Risk that employer contract amendments do not conform to applicable federal/state laws
2. Controls to mitigate the risk
- See section I.B., Local Public Agency Plans Contracting with a Public Pension System
  - Utilize legal counsel to review employer contract amendments

## **XIV. Contracting with Suppliers of Goods and Services**

### ***A. Operations Contracts (Ordinary)***

1. Risks
- Risk that object of contract is not adequately defined
  - Risk that contract terms are not complete or adequate for the project/tasks required
  - Risk that bid procedures are not properly followed
  - Risk that the contracting process is difficult to comply with, increasing the potential for non-compliance and making it difficult for business units to meet their objectives
  - Risk that adequate due diligence is not performed for major suppliers before hiring
  - Risk that financial status of major suppliers is not monitored through review of audited financial statements, popular press articles, and internet searches
  - Risk that contractor does not do adequate background history check for all hires who work on the contract

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### 2. Controls to mitigate the risks

- Utilize legal counsel to review contracts
- Ensure both parties have a mutual understanding of the terms of the contract
- Provide a sample of the contract up front (in the RFP) when negotiating a deal with the vendors, or provide a sample contract at the start of the negotiations
- Ensure that all relevant pension fund staff have reviewed the Request for Proposal and/or proposed contract
- Do an Internet search of applicant's possible involvement in lawsuits, settlements, fraud, and kickbacks
- Request detailed description of hiring practices and procedures from the vendor
- Include in the contract the ability of the System to do independent background checks (i.e., require SSN/INS # and date of birth for all contract employees)

### ***B. Third-Party Administrator (TPA) Contracts***

#### 1. Risks

- Risk that adequate due diligence is not performed on TPA applicants
- Risk that contract employees engaged in inappropriate activities before hire and/or during employment, including criminal activity, unethical conduct, and identity theft
- Risk that contract provisions are inadequate
- Risk that TPA does not understand its fiduciary duty
- Risk that pension fund management does not appropriately monitor the TPAs
- Risk that an annual SAS#70, Type II, audit is not performed by the TPA's Auditor, transmitted to the pension plan and reviewed by the pension plan staff
- Risk that TPA's audited financial statements are not received/reviewed by pension plan staff
- Risk that contract does not contain an audit clause
- Risk that third-party administrator has a conflict of interest
- Risk that third-party administrator destroys records that should be maintained

#### 2. Controls to mitigate the risks

- Develop policies and procedures for performing due diligence
- Do Internet search of applicant's possible involvement in lawsuits, settlements, fraud, and kickbacks
- Require a clause in the contract with the vendor for background checks, including evidence to show that detailed background checks have been conducted
- Obtain copies of SSNs for contract employees, thus permitting the retirement system to conduct its own background checks and run edits on SSNs
- Develop standard contract provisions
- Include fiduciary duties terms in the contract
- Require that contract managers have training in monitoring compliance
- Require a SAS#70, Type II report, in the RFP and in the contract
- Require that contractor forward its audited financial statements to contract manager
- Require sign-off by contract managers that they have reviewed financial statements
- Require standard contract language in request for proposals (RFPs) and contracts
- Utilize legal counsel to review TPA contracts
- Require TPA to complete financial disclosure/conflict of interest statement annually
- Include in the contract the ability of the system to do independent background checks (i.e., require SSN/INS # and date of birth for all contract employees)

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- Include a clause in the contract that identifies the owner of the records
- Determine retention schedule for records and include in contract, or, otherwise communicate to TPA

### **XV. Business Continuity Planning**

#### 1. Risks

- Risk that there are no business continuity plans to continue operations in event of disaster
- Risk that the disaster plan does not adequately address important issues such as utility supply, travel requirements, hot site location, etc.
- Risk that business continuity plan is not tested or periodically reviewed and updated
- Risk that external service providers do not have business continuity plans

#### 2. Controls to mitigate the risks

- Assign specific staff responsibility and accountability for the business recovery plan
- Create a risk-based business continuity plan with cooperation from business areas that identifies critical process and assigns priorities so that systems are operational within 72 hours in an actual emergency. Include essential issues in the business continuity plan such as resuming IT mainframe access off-site; resuming phone and LAN based services; serving participants face to face; purchasing and obtaining equipment; providing mail services; and relocating users
- Develop checklists and/or written procedures for business recovery, including expected results; review/update these periodically
- Develop a schedule for reviewing and maintaining the business recovery plan, including a reasonable budget for testing and maintaining key components (such as disaster recovery of information technology components) to ensure the items/equipment/data exist, are useful, and could replace live operations
- Discuss business continuity plans with external service providers and determine how they will continue business in event of disaster

### **XVI. Cash Forecasting**

[Note: This section is limited to activities related to cash forecasting for a separate benefits entity or division. Cash forecasts should be an integral part of a comprehensive cash management system that is generally run by the accounting and investment divisions of a public employee retirement system or by a separate government investment agency. Risks of a comprehensive cash management system would be best addressed in a document on investment risks.]

#### 1. Risks

- Risk that there are no comprehensive policies and procedures for cash forecasting of various benefit and operational activities
- Risk that there is no coordination between cash forecasting of benefits and operational activities with the cash management program of the accounting division and/or investment division/agency
- Risk that sources and uses of cash for benefit and operational activities are not accurately forecast
- Risk that all sources and uses of cash for benefit and operational activities are not included in the forecast
- Risk that cash is not available to pay benefits and operational expenses
- Risk that cash forecasts are not updated to reflect benefit structure changes
- Risk that investment returns are not maximized due to poor cash forecasting

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### 2. Controls to mitigate the risks

- Assign a cash flow manager
- Create comprehensive written policies and procedures for cash forecasting of various benefit and operational activities
- Develop written policies and procedures for coordinating cash forecasting of benefits and operational activities with activities of the accounting division and/or investment division/agency
- Create a comprehensive listing of disbursements for benefits (retirement, disability, death), refunds, and operational expenses; and create a comprehensive listing of various cash receipts such as employer contributions, member contributions, and service purchases
- Hire staff who are knowledgeable in cash forecasting
- Perform an asset/liability study (See section XII. Actuary)
- Prepare and document cash forecasts at least two years into the future
- Compare and document actual cash flows with the cash forecast monthly, adjusting remaining cash forecasts and the cash forecasting process as appropriate
- Monitor employment cycles, external events, and governing body actions which may affect cash flows

## **XVII. Depositing Cash**

(See also sections V.A. and XIII.C. and D.)

### 1. Risks

- Risk that there are no comprehensive policies and procedures for receiving and depositing cash, checks, and electronic forms of payment
- Risk that there is inadequate separation of duties for receiving and recording cash receipts
- Risk that payments of employer and/or member contributions are incorrect
- Risk that contributions received are not credited to the correct accounts
- Risk that employer and member contributions are not received timely or at all
- Risk that pension system staff does not follow up with employers when contributions are not received
- Risk that payments are not deposited the same day as received
- Risk that investment division/agency is not notified of cash deposits
- Risk that cash will be embezzled

### 2. Controls to mitigate the risks

- Create comprehensive written policies and procedures for receiving/depositing cash
- Create adequate separation of duties for handling cash receipts and cash accounting
- Use a bank lock box for receiving cash and checks
- Reconcile cash receipts to employer payroll reports received
- Match contribution rates paid to contribution rates required by actuaries
- Send quarterly statements to employers listing employer and member contributions received by plan, and employer beginning and ending account balances so that employers can reconcile their books to pension system books
- Perform employer payroll audits
- Create a system that receives data promptly and records information into each member's account promptly
- Maintain list of anticipated employer payroll reports and check them off when received
- Follow up on reports not received timely from employers
- Implement statutes and/or rules that penalize employers for submitting reports late

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- Track deposits to determine if 100% of receipts are deposited same day
- Notify the investment division/agency of deposits received

### **XVIII. Managerial Accounting and Reporting**

#### 1. Risks

- Risk that pension plan is costly and inefficient because the true costs of various processes are not known
- Risk that pension plan creates processes that are costly and inefficient because the true costs are unknown
- Risk that costs relevant to various processes are grouped and inappropriately hidden in general classifications such as overhead and administration
- Risk that the pension plan does not have an activity-based cost accounting system that tracks the costs of various processes
- Risk that the pension plan does not have staff that are knowledgeable and current in cost/managerial accounting and GASB requirements

#### 2. Controls to mitigate the risks

- Create a charter that includes the objectives of cost/managerial accounting
- Perform costing studies of existing processes and reengineer as appropriate
- Perform costing studies as new processes are created
- Hire staff who are knowledgeable and current in cost/managerial accounting
- Encourage existing staff to obtain training in and certifications in cost/managerial accounting. The most relevant certifications are the CMA, CFM, CGAP, and CPA
- Implement an activity-based costing system
- Send periodic internal financial reports to an independent Board/Audit Committee

### **XIX. Financial Accounting and Reporting by Management**

#### 1. Risks

- Risk that financial statements, both interim and year-end, do not provide useful information for the various groups of users
- Risk that financial information is not relevant and reliable
- Risk that financial statements do not fully disclose all material items
- Risk that financial statements do not disclose sufficient detail (statements, footnotes, and required supplementary information) to permit analyses and understanding of each area
- Risk that financial statements are not organized and formatted to permit analyses and understanding
- Risk that financial statements have material errors and/or irregularities
- Risk that financial statements do not conform to generally accepted accounting principles (GAAP/GASB)
- Risk that financial statements are not fully informative because they present only the minimum disclosures required by GAAP/GASB
- Risk that Management's Discussion and Analysis does not explain the reasons behind the numbers and the changes in these numbers from prior periods (i.e., transparency)
- Risk that financial statements are not provided in a timely manner for auditing

#### 2. Controls to mitigate the risks

- Create a charter that includes the objectives of financial reporting, including both interim and year-end financial statements, and *ad hoc* reports

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- Hire staff with relevant training and professional certifications and encourage and facilitate existing staff in obtaining training and professional certifications. Appropriate certifications include the CPA, CMA, CFM, CFA, CGAP, and CGFM
- Pay for professional exams, professional meetings, continuing professional education, and annual certification maintenance fees
- Encourage accounting staff to participate in professional societies and sit on boards of these societies
- Provide continuing education for staff involved with preparation of financial statements
- Hire reputable independent, external CPA firm
- Compare reporting to applicable standards (e.g., GASB, AICPA, etc.) and other pension fund reports
- Compare reports to other reports receiving the GFOA Certificate of Achievement for Excellence in Financial Reporting
- Hire temporary employees to assist in the timely preparation of year-end statements
- Perform interim closings (for example, quarterly) to improve the timeliness and efficiency of year-end closings
- Rotate external auditors periodically

### **XX. External Audit Risks**

#### 1. Risks

- Risk that external audit firm is not independent
- Risk that external audit firm does not have sufficient knowledge of public pension plan in order to perform a proper audit (deficient knowledge of the industry)
- Risk that persons (engagement partner, manager and on-site supervisor) assigned to the audit do not have sufficient experience and knowledge of the public pension plan
- Risk that the external auditor has a conflict of interest
- Risk that audit firm does not have access to adequate actuarial staff to evaluate actuarial information
- Risk that firm does not have a CPA license required by the state in which audit occurs
- Risk that key personnel (engagement partner, manager, and on-site supervisor) assigned to the audit do not have the CPA license
- Risk that external auditors fail to identify material misstatements or omissions in financial statements
- Risk that external auditors do not identify presentations that are not in accordance with GAAP/GASB pronouncements
- Risk that external auditors do not identify material weaknesses in internal controls
- Risk that external auditors do not perform enough work to support their conclusion/opinion (may result from low-balling when bidding the contract)

#### 2. Controls to mitigate the risks

- Hire reputable independent, external CPA firm
- Check all contracts to determine what consulting and other roles the audit firm is performing for your system, and determine if there is a conflict of interest
- Limit the external audit firm to performing audit and test services only
- Require periodic mandatory rotation of audit partners or even of external audit firms
- Evaluate periodically the independence of the external audit firm and key employees
- Require the audit committee to approve all assignments made in addition to the annual audit of the financial statements

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- Require experience for the firm, the engagement partner, the audit manager, and the on-site supervisor. A good minimum qualification is to require a CPA certificate of all key personnel, including the on-site supervisor. All key personnel and changes in key personnel should be approved by the contract manager in advance
- Monitor CPA firm work during engagement including weekly status meetings
- Interact with/discuss issues with key staff (i.e., Partner, Manager, On-site supervisor)
- Follow-up periodically with the accounting manager to determine CPA firm progress during engagement, work quality, level of understanding, customer service, etc.
- Perform review of CPA work papers (by Internal Audit)
- Require that external auditors complete financial disclosure/conflict of interest statement annually
- Require that external auditors do not perform any non-audit services which go beyond the Sarbanes-Oxley Act and SAS requirements
- Review the Sarbanes-Oxley Act to determine if there are items which your system wishes to adopt voluntarily
- Develop written policy on the responsibilities of external auditors

### **XXI. Internal Audit Risks**

#### 1. Risks

- Risk that there is no internal auditor(s)
- Risk that the internal audit function is not organizationally independent of operations (improper reporting structure)
- Risk that internal auditors do not have a effective working relationship with the board of trustees, management, and/or staff
- Risk that internal audit management and/or staff do not have sufficient expertise/training in auditing public pension systems
- Risk that internal audit plan is not risk-based, is inadequate, and/or is not updated
- Risk that internal audits are not performed in accordance with Standards for the Professional Practice of Internal Auditing (SPPIA)
- Risk that internal auditors have a strained relationship with pension system management and staff and do not communicate adequately with auditees in order to obtain their support for corrective risk mitigation strategies
- Risk that internal audit function is not, or is not perceived as, adding value to system
- Risk that internal audit staff are not encouraged to obtain appropriate profession certifications, such as the CIA, CISA, CPA, CFE, CIDA, CGFM, CMA, CGAP, CFM or other relevant certifications
- Risk that internal audit staff are not encouraged to participate in relevant professional societies and to obtain continuing professional education
- Risk that internal audit workpapers are not retained for a sufficient period of time

#### 2. Controls to mitigate the risks

- Develop an audit scope that is sufficient, refined, and limited so as to accomplish audit objectives in a reasonable time frame
- Require that internal audit have a charter approved by the board
- Review internal audit reporting structure periodically
- Require Chief auditor to meet with board and management periodically
- Participate in periodic peer reviews

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- Utilize tools such as checklists, guides, and structured review programs for any form of quality assessment—internal, external, or self-assessment
- Perform a risk assessment of organization and Internal Audit
- Require training in auditing and training in public pension plans
- Encourage internal auditors to obtain relevant professional certifications, such as the CIA, CISA, CPA, CMA, CFM, CFA, CIDA, CGAP, and CGFM
- Encourage internal auditors to participate in professional societies and sit on boards of these societies
- Pay for professional exam fees, professional meeting costs, continuing professional education and for annual certification maintenance fees
- Send customer satisfaction survey to auditee at end of each audit or assignment
- Require independent legal compliance review to determine that the plan conforms to Internal Revenue Service requirements
- Maintain audit records for at least seven years
- Conduct independent legal compliance review to determine that the plan conforms to state statutory requirements
- Develop an internal audit record retention policy

## XXII. Consultants

### 1. Risks

- Risk that contract manager does not have sufficient experience and expertise to manage the consultant contract appropriately
- Risk that contract manager does not hold consultants accountable for contracted deliverables
- Risk that designated contract manager is not the appropriate person to manage the consultant contract (examples: Project Manager managing the oversight consultant's contract; consultant managing another consultant's contract)
- Risk that consultant does not have adequate skills or expertise in the area of hire
- Risk that consultant is not eligible to work in the United States
- Risk that consultant hiring practices do not include a thorough background check of both resident and non-resident foreign staff
- Risk that no one has responsibility for performing background checks of information systems consultants to determine that they have appropriate backgrounds to have access to key systems (for example, pension system staff assume in error that the consultant company performs background checks but it does not)
- Risk that consultant has employees who engaged in inappropriate activities before hire and/or during employment, including criminal activity, unethical conduct, and identity theft
- Risk that consultant has a conflict of interest
- Risk that consultant is hired because of political connections
- Risk that consultant does not understand the organization
- Risk that consultant does not understand the fiduciary responsibility to members, retirees, and beneficiaries
- Risk that payments to consultant are not tied to deliverables
- Risk that consultant does not transfer knowledge to pension plan staff or that staff do not acquire knowledge from the consultant, resulting in consultant's continued presence
- Risk that the pension system hires consultants to perform work that could be done by competent pension system staff

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- Risk that contract with consultant does not include all provisions to ensure that the consultant is an independent contractor under applicable laws and U.S. Department of Labor definitions
2. Controls to mitigate the risks
- Ensure internal staff have sufficient experience and expertise to manage consultant contracts, including technical knowledge of the subject of the contract
  - Monitor contract management activities to ensure contract manager is adequately managing the contract, i.e., holding consultant accountable for deliverables and measuring deliverables against quality standards
  - Require minimum levels of experience and expertise for the consultant
  - Require a clause in the contract with the consultant for background checks, including evidence to show that detailed background checks have been conducted
  - Confirm that consultants are eligible to work in the United States
  - Use the Terrorist Database issued by the U.S. Treasury or public databases for convicts to assure that consultants meet background criteria
  - Establish a process, including assignment of responsibility, to determine that information systems consultants have appropriate backgrounds to have access to key systems
  - Review resumes to determine if consultants have the required skills and experience
  - Obtain copies of SSNs for employees of the consultant, thus permitting the retirement system to conduct its own background checks and run edits on SSNs
  - Provide the consultant with an orientation to the organization
  - Implement contracting standards and a uniform process
  - Establish an independent contracting and RFP office
  - Establish deliverables in the contract which are tied to payments in the contract and include penalties for not meeting deliverables in expected timeframes
  - Establish the process by which the pension plan employees become competent to maintain and enhance the products of the consultant, if applicable
  - Require Board approval for contracts that exceed a certain dollar amount
  - Require that consultants complete financial disclosure/conflict of interest statement annually
  - Verify invoices from consultants to determine appropriateness of charges
  - Make certain that contracts, requirements, and working conditions of the consultant meet the U.S. Department of Labor definition of a consultant

### **XXIII. Information Systems Acquisition and Development**

1. Risks
- Risk that project goals do not support the mission and strategic plan of the pension system
  - Risk that pension plan does not have information systems policy that includes the entire system development life cycle (SDLC)
  - Risk that SDLC does not have a formal quality assurance process
  - Risk that project implementation does not follow a body of standards
  - Risk that the process for system acquisition or development is not monitored by an individual or oversight committee
  - Risk that projects are not formally approved prior to initiation and resource allocation
  - Risk that project is not adequately scoped, defined, and justified
  - Risk that systems development life cycle process is inadequately managed

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- Risk that pension plan staff/manager does not have the technical expertise to effectively manage the project
  - Risk that project does not have adequate support from the Board, Executive, Department, or user groups
  - Risk that a formal project management process is not used. Formal project management includes project methodology and plans, project tools, realistic project milestones, and project deliverables that enable project manager to efficiently manage, control, and direct the project. Project management also includes management of risk, issues, and scope changes; a criticality assessment of the project; and management and oversight appropriate to the criticality level.
  - Risk that formal development standards are not followed
  - Risk that project roles and responsibilities are not clearly defined
  - Risk that project tools are not used in a consistent manner
  - Risk that project deliverables are not consistently developed
  - Risk that payments are not tied to deliverables
  - Risk that test plans and test data are not adequate
  - Risk that acceptance testing is not done or the test period is shortened to meet deadlines
  - Risk that volume and stress testing is not performed
  - Risk that system acceptance criteria is not identified, documented, evaluated, or approved
  - Risk that appropriate personnel are not consulted throughout the project, such as those responsible for disaster recovery, security, and telecommunications
  - Risk that security and audit functions are not built into the system
  - Risk that user requirements or business objectives are not met
  - Risk that inadequate resources are available to maintain the system
  - Risk that ongoing maintenance costs have not been included in cost-benefit analysis or that management does not fully realize future costs to maintain the system
2. Controls to mitigate the risks
- Implement a system development life cycle (SDLC) policy
  - Develop a formal information technology (IT) quality assurance process as part of SDLC
  - Create guidelines for project initiation, objectives, success criteria, scope, justification, and approval
  - Follow a body of standards such as the Institute of Electrical and Electronics Engineers (IEEE) or Control Objectives for Information Technology (CoBIT) from the Information Systems Audit and Control Association (ISACA)
  - Ensure that test plans are thorough, complete, and reliable (developed by operations staff along with user groups)
  - Ensure that system is tested by both functional and technical staff
  - Require that all project managers have adequate managerial/technical expertise
  - Encourage information technology staff to become certified in relevant areas
  - Require a formal project management process that ensures following the chosen standards for all projects
  - Require that payments are tied to project deliverables
  - Develop a quality standard against which deliverables are measured
  - Provide milestone reports to oversight committees and management
  - Involve personnel from all impacted units
  - Involve auditors during the project to evaluate system controls and any changes to controls over business practices

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- Ensure audit trails and security functions in line with the pension fund's security practices are included in the system
- Provide training in project management, systems development and implementation, quality practices, and standards
- Evaluate the need for system volume and stress testing
- Perform management oversight reviews to assure that system development projects comply with applicable standards, regulations, controls, and management practices
- Consider active user participation and sign-off on project activities such as requirements, specifications, design approaches, test plans, controls procedures, and file conversion results
- Develop system acceptance criteria
- Ensure that system and acceptance testing is performed as planned
- Include ongoing maintenance costs in the cost-benefit analysis and discuss with management
- Determine whether adequate, skilled resources are available to maintain the system

### **XXIV. Information Security**

#### 1. Risks

- Risk that pension plan does not have or will not develop a system of information security controls to maintain the integrity, confidentiality, and availability of pension system data
- Risk that management may not adequately communicate information security requirements to staff
- Risk that information security can be breached by knowledgeable programmers/users
- Risk that management may not adequately enforce information security controls
- Risk that individuals inside/outside pension plan could bypass information security controls

#### 2. Controls to mitigate the risks

- Create information security policy(ies) and procedure(s)
- Implement a formal plan of communication of information security policies/procedures
- Create physical and logical security systems for existing and developing information systems
- Test security systems periodically (by independent company or by internal audits) and develop a secure testing environment that precludes alteration of live data
- Monitor the security detection system and reports according to a regular schedule
- Develop an incident response plan with clearly defined staff roles and responsibilities, including communication with the media. Test the plan periodically, document results, resolve issues, and update the plan.
- Encourage information technology staff to become certified in relevant areas

### **XXV. Legal Services**

#### 1. Risks

- Risk that system does not have an adequate charter that defines the services to be performed by the in-house legal staff. These services include giving advice and consultation, and providing representation at hearings and for litigation
- Risk that pension plan does not have adequate legal counsel in-house (legal counsel with training and expertise in laws and litigation affecting public pension systems)

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- Risk that pension plan does not obtain adequate help from outside counsel when necessary
  - Risk that legal office does not provide adequate advice and consultation in the areas of membership, benefit entitlement, fiduciary responsibility, ethics, contracting, public records, open meetings, and investments (securities, real estate, and alternative investments) and does not provide adequate advice in drafting legislation, regulations, and policies
  - Risk that legal office does not provide adequate representation before the Office of Administrative Hearings and in court cases other legal actions
2. Controls to mitigate the risks (See also section I.A. of this document)
- Create a charter with the objectives for the legal services unit
  - Specify the experience and skills required for in-house legal staff
  - Determine the skill sets and analyses to be obtained from outside legal counsel
  - Develop remedial legislation to correct inconsistent or confusing language
  - Develop administrative rules that accurately reflect the intended implementation of the statutory language

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