SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM
M E M O R A N D U M

DATE: August 24, 2017

TO: Audit Committee

CC: SDCERS Board of Administration
Mark Hovey, SDCERS Chief Executive Officer
Marcelle Rossman, SDCERS Chief Benefits Officer
Johnny Tran, SDCERS Chief Compliance Officer/General Counsel

FROM: Lee Parravano, SDCERS Internal Auditor

SUBJECT: Purchase of Service Credit (PSC) Audit

Enclosed is the Purchase of Service Credit (PSC) program Internal Audit. Overall, it was determined SDCERS has excellent controls in place to correctly calculate PSC contracts. Opportunities for improvement and consideration were also identified.

Based on this audit, there were 10 total recommendations: nine recommendations are directed to SDCERS' management, and one recommendation is directed to SDCERS' Board. SDCERS' management agrees with eight of the recommendations and partially agrees with one of the recommendations. SDCERS' management comments are attached to this report.

Details can be found in the Audit Results section of the report. SDCERS' management comments are attached to this report.

SDCERS

San Diego City Employees' Retirement System

Internal Audit Report

Purchase of Service Credit (PSC)

Prepared by:
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EXECUTIVE SUMMARY

The objective of the audit was to evaluate the operational controls used to setup and calculate Purchase of Service Credit (PSC) contracts and to verify the accuracy of transactions. Service Credit represents the amount of time a Member has in SDCERS and is one of the factors used in calculating a Member's retirement benefit. Generally, a Member may purchase Service Credit for a prior period they were employed by the Plan Sponsor and did not receive Service Credit (e.g., Member is on Long Term Disability). Additionally, eligible Members can purchase up to five years of additional service credit, unrelated to actual years worked, to apply toward their vesting requirements and service retirement benefits.

Based on the audit work performed, I conclude SDCERS has excellent controls in place to correctly calculate PSC contracts. Because of the diligent work performed by staff and the controls in place, 99.35% of the costs of all tested PSC contracts were correctly calculated and provided to the Member in less than 9 days after the Member's request.[1]

Other notable strengths identified during the audit include:

- Validation checks within SDCERS' pension administration system, IRIS, assist in ensuring compliance with the Plan and Internal Revenue Service (IRS) rules.
- The purchase of five year PSC contracts were correctly limited to San Diego County Regional Airport Authority (Airport) Members hired prior to October 2, 2006, San Diego Unified Port District (Port) Members hired prior to October 1, 2005, and City of San Diego (City) Members hired prior to July 1, 2005.
- SDCERS correctly did not issue any five year PSC contracts to Airport or Port Members after January 1, 2013.
- Member accounts accurately reflect amounts paid on terminated contracts.
- The price of a five year contract, when compared to a 2 year and 3 year contract, is reasonable.
- SDCERS is reconciling PSC contracts from IRIS to the General Ledger.
- There were no voided contracts that have been incorrectly purchased.

However, the following issues were identified that should be addressed.

IRIS Access Rights

It is SDCERS' policy to grant access to computer systems and network services at the minimum level required for the employee to perform their duties. System access rights must be approved by a supervisor and documented. There was an instance where system access rights were granted to two Information Technology (IT) contractors without having supervisor approval or documentation. As of January 2017, the system access rights were removed from the individuals noted.

Additionally, it was noted that some employees have system access rights that exceed the minimum level necessary to complete their duties. These rights allow non-Benefits Administration Staff to modify PSC contracts (e.g., Purchased Service Credit, Total User Cost and Allocation between Normal, COL Annuity and SS contributions accounts), which are not the duties of these employees.

[1] Based on audit sample.

EXECUTIVE SUMMARY (Continued)

PSC contracts calculated between July 1, 2016 and July 20, 2016

In general, a PSC contract is based on a Member's age, contribution rate, years of service and highest annual pensionable salary at the time the PSC contract is calculated. SDCERS did not use the new Member contribution rates for Fiscal Year 2017, which were effective July 1, 2016, until July 20, 2016. This was done purposely by staff to ensure IRIS did not create erroneous Member contribution variances for June 2016 Member contributions reported and remitted to SDCERS in July 2016. Not uploading new Member contribution rates until July 20, 2016 had the unintended effect of underpricing PSC contracts calculated and created during this period. The total underpriced amount of the contracts processed during this time period is $415.47.

Expiration of PSC Contracts

PSC contracts are guaranteed for a period of no longer than 60 days from the date of the PSC contract is calculated. SDCERS intentionally programmed IRIS to automatically void a PSC contract at 12:01 am on the 63rd day to provide staff processing time. This programming allows a Member to turn in a signed PSC contract on the 60th day, and gives staff until the 63rd day to complete the process. The date on PSC contract(s) mailed to Members, however, incorrectly indicates the contract expires on the 63rd day instead of the 60th day.

Six of the 25 PSC contracts selected for testing were turned in after the 60 day deadline but before the 63rd day indicated on the PSC contract. Three of those contracts were received by SDCERS on the 63rd day. Staff had to manually recreate these contracts to honor the amounts and dates included in the PSC contract because IRIS had already voided these contracts. Those three manually recreated contracts contained allocation errors between the Normal, COL Annuity and SS contribution accounts due to staff using incorrect allocation percentages. The allocation to a Member's Normal, COL Annuity and SS contribution accounts can impact a Member's retirement benefit. The allocation errors were less than $100 for each Member.

PSC Contract Payment

PSC contract payment must be made within 60 days of the date the Member signs a proposed PSC contract. For two Members selected for testing payment on their PSC contracts were received after the 60 day deadline. SDCERS' staff, however, was working with the Members to complete their purchase prior to the deadline.

PSC Rate

One PSC contract selected for testing incorrectly used the General Member contribution rate instead of the Safety Member rate on a "Recruit Time" PSC contract. This caused the PSC contract to be underpriced by $2,663.98.

Previously Refunded Contributions

A Member who is re-employed by the City or the Airport may repay the contributions the System previously refunded to the Member, plus interest at the actuarial interest rate. The cost of the contract must be allocated to the Normal, COL Annuity and SS contribution accounts. The Board Rules or Plan do not state how to allocate those repaid contributions.

Additionally, this Member's PSC contract was calculated using prorated interest in the first year. While the method is reasonable there is no provision in the Board Rules or Plan Documents to calculate a refunded PSC with prorated interest.

EXECUTIVE SUMMARY (Continued)

Deferred Member

Deferred Members are not eligible to purchase Service Credit while on deferred status. One Member selected for testing completed her PSC contract while on deferred status. This occurred because the City did not communicate to SDCERS that the Member was on deferred status until after the PSC contract was completed. In this instance, SDCERS' General Counsel determined that the Member's PSC contract is valid and should not be voided.

Pre-Tax vs. Post-Tax

In most cases, the taxable portion of a Member's retirement benefit depends on the amount of pre-tax and post-tax contributions made by the Member. Incorrectly indicating contributions as pre-tax or post tax would result in incorrect 1099-R reporting to the IRS. For two Members selected for testing, staff incorrectly indicated the payment on the PSC contracts came from pre-tax or post-tax funds.

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Based on this audit, there were 10 total recommendations: nine recommendations are directed to SDCERS' management, and one recommendation is directed to SDCERS' Board. SDCERS' management agrees with eight of the recommendations and partially agrees with one of the recommendations. SDCERS' management comments are attached to this report.

Internal Audit would like to thank SDCERS' staff for their assistance and numerous courtesies extended during the completion of this audit.

The information in this report is intended solely for the use of SDCERS' Audit Committee, Board of Administration, and management and is not intended to be, and should not be, used by anyone other than these specified parties.

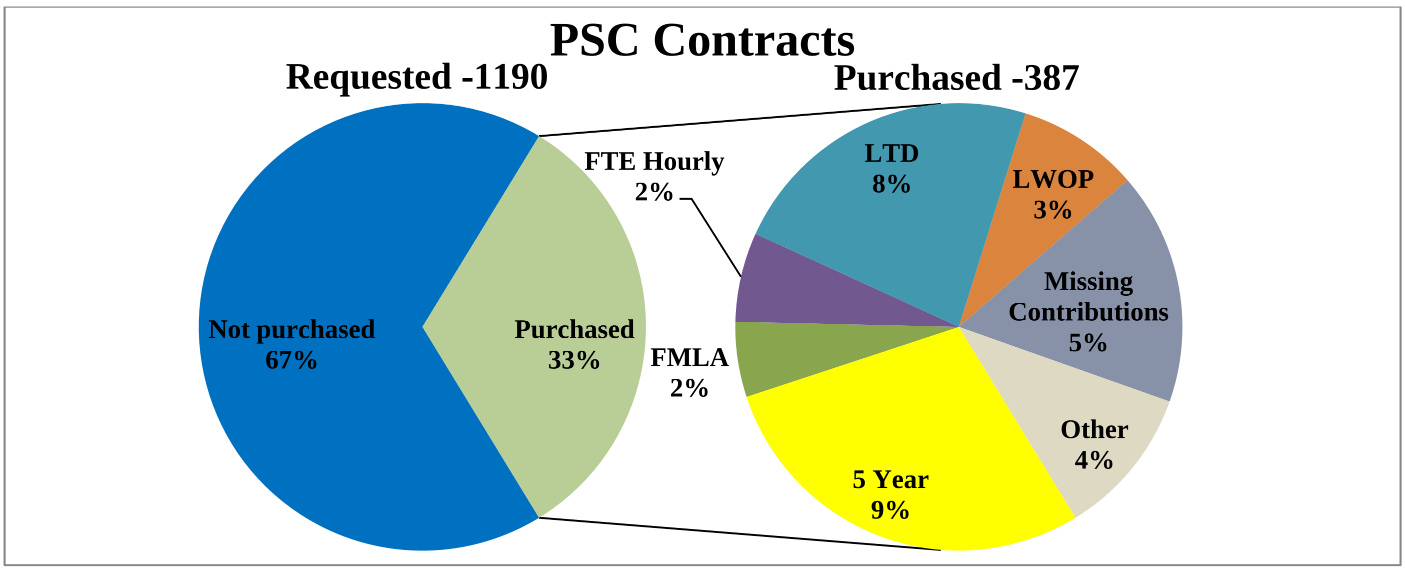
INTRODUCTION

BACKGROUND

Service Credit represents the amount of time a Member has with SDCERS and is one of the factors used in calculating a Member's benefit. Generally, a Member may purchase Service Credit for a prior period they were employed by the Plan Sponsor and did not receive Service Credit (e.g., Member is on Long Term Disability). Additionally, eligible Members can purchase up to five years of additional service credit, unrelated to actual years worked, to apply toward their vesting requirements and service retirement benefits.

In general, the PSC program is intended to be cost neutral to the System. The cost to purchase service credit is generally based upon the Member's age, years of service and highest annual Pensionable Salary at the time the PSC contract is calculated.

Upon receipt of a PSC contract request, SDCERS calculates the cost for all periods of time available for the Member to purchase. A Member may purchase all or part of any PSC contract they are eligible to purchase, but there is no obligation to purchase any PSC contract(s). The chart below provides details on the PSC contracts requested and purchased during the audit period from July 1, 2015 to December 31, 2016.



PRIORITY RATING PROCESS

To assist management in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed a high, medium, or low priority as follows:

High - Represents a finding requiring immediate action by management to mitigate risks associated with the process being audited.

Medium - Represents a finding requiring timely action by management to mitigate risks associated with the process being audited.

Low - Represents a finding for corrective action by management to mitigate risks with the process being audited.

Informational – Represents a finding to educate the Board or management.

AUDIT RESULTS

Based on detailed testing, strengths were identified, as well as issues that should be addressed to further strengthen operational controls used to setup and calculate PSC contracts.

Strengths Identified

SDCERS has a variety of controls in place to correctly calculate PSC contracts. Most of these controls have been built into IRIS. IRIS assists staff in responding to Member requests in a timely manner by identifying Service Credit that is eligible for purchase, assisting in the calculation of the contracts, and generating letters and contracts that inform the Member of critical information such as the cost of the contract(s), expiration date of the contract(s), and eligible payment options.[2] On average, SDCERS Benefits Administration staff calculated and provided PSC contracts to Members in less than 9 days after the Member's request.[3] This response time is praiseworthy given the level of effort required to correctly calculate a PSC contract.[4] Additionally, 99.35% of the costs of all PSC contracts tested were correctly calculated.[5]

Validation checks within IRIS are a key preventative control that ensures compliance with the Plans and IRS rules. For example, SDCERS has programmed IRIS to: 1) Only allow Grandfathered Members the ability to make post-tax payments, 2) Prevent a Deferred Member from completing a PSC contract, and 3) Prevent Airport and Port Members from completing a five year PSC contract. These validation checks eliminate potential errors from occurring and are an example of the thorough job staff performed when designing IRIS.

Other notable strengths identified during the audit include:

- The purchase of five year PSC contracts were correctly limited to Airport Members hired prior to October 2, 2006, Port Members hired prior to October 1, 2005, and City Members hired prior to July 1, 2005.
- SDCERS correctly did not issue any five year PSC contracts to Airport or Port Members after January 1, 2013.
- Member accounts accurately reflect amounts paid on terminated contracts.
- The price of a five year contract, when compared to a two year and three year contract, is reasonable.
- SDCERS is reconciling PSC contracts from IRIS to the General Ledger.
- There were no voided contracts that have been incorrectly purchased.

The findings listed below should be addressed to further strengthen controls.

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[2] Members also have access, via the Member Portal, to estimate the cost of a five year contract. Five year PSC contracts are the most popular contracts requested and made up approximately 35% of all PSC contracts requested during the audit period.
[3] Based on audit sample. 32% of these Members requested a PSC contract(s) via the Member portal.
[4] Includes investigating any "Unknown" service records. See Plan Sponsor Contribution & Reporting Audit for the City of San Diego for the period July 1, 2015 through June 30, 2016 for more information concerning "Unknown" service records..
[5] Based on audit sample.

Finding #1: Certain individuals had access rights in IRIS that were not approved by a supervisor. Additionally, IRIS access, for certain employees, exceeded the minimum level required to perform their duties.

Priority Rating: Medium

IRIS Access Rights

SDCERS' Information Technology Policy states that access is granted to computer systems and network services at the minimum level required for the employee to perform and complete their duties. Any requested change to system access rights must be approved by a supervisor and documented on an Account Change Request form.

There was an instance where system access rights were granted to two Information Technology contractors without having the required Account Change Request forms approved by a supervisor. This occurred because both contractors had "IRIS Administrator" roles within IRIS, which allowed them to grant access rights to one another. The contractors were attempting to investigate an issue reported by SDCERS' staff. Their customer service efforts are appreciated, but controls should not be circumvented to expedite the solution of reported end user issues. As of January 2017, the system access rights were removed and as of May 19, 2017 the "IRIS Administrator" role was removed from all contractors. Additionally, as of May 19, 2017 only SDCERS' System Administration Manager and his backup have the "IRIS Administrator" role.

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Because the system access rights have been removed from the contractors and the "IRIS" Administrator" role is now limited to SDCERS' System Administration Manager and his backup there is no additional recommendations related to approval of system access rights within IRIS.

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IRIS Modification Access

When IRIS was put into service in May 2014, roles and responsibilities were assigned to users based on the initial design of IRIS. To ensure the rights are still appropriate, each year management reviews IRIS roles assigned to each employee and makes any modifications as necessary. During the audit period it was noted that some employees[6] have system access rights that exceed the minimum level necessary to complete their duties. These rights allow non-Benefits Administration staff to modify PSC contracts (e.g., Remaining Principal Balance, Total User Cost and Allocation between Normal, COL Annuity and SS contributions accounts). The ability to modify most elements of a PSC contract should be limited to Benefits Administration staff only.

Recommendation 1: SDCERS' staff should review and restrict the ability of non-Benefits Administration staff to modify elements of PSC contracts.

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[6] Employees with the Role of MS-Processor, MS-Reviewer and MS-Supervisor.

Finding #2: PSC contracts calculated between July 1, 2016 and July 20, 2016 are underpriced.

Priority Rating: Medium

In general, a PSC contract is based on a Member's age, contribution rate, years of service and highest annual pensionable salary at the time the PSC contract is calculated. PSC contracts are created in IRIS. SDCERS adopts Member contribution rates each fiscal year and they are uploaded into IRIS.

Staff did not upload new Member contribution rates for Fiscal Year 2017, which were effective July 1, 2016, until July 20, 2016. This was done purposely to ensure IRIS did not create erroneous Member contribution variances for June 2016 Member contributions reported and remitted to SDCERS in July 2016.[7] Not uploading new Member contribution rates until July 20, 2016 to avoid Member contribution variances, however, had the unintended effect of underpricing PSC contracts calculated and created during this period.

One of the contracts selected for testing was created on July 14, 2016. This Member's PSC contract was underpriced by $19.40.

Six other PSC contracts were completed during the time period July 1, 2016 to July 20, 2016. The total underpriced amount of the contracts processed during this time period is $415.47.

In July 2017, SDCERS tested to see if IRIS can utilize multiple Member contribution rate tables. Each table would contain a start and end effective date. IRIS would use these tables and effective dates to verify Member contribution amounts and price PSC contracts. This ability would also enable SDCERS' staff to upload rates for future events (e.g., Member contribution rates are generally adopted in March but are not effective until July of that year).[8] Staff represents that, within the testing environment, IRIS was able to handle multiple rate tables without issue.[9]

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This finding was discussed with management in early July 2017. Management correctly reacted by delaying all Fiscal Year 2018 PSC contract calculations until the new 2018 rates were updated in IRIS. This prevented any additional incorrect PSC contract calculations. Because management intends to load multiple Member contribution rate tables into IRIS, with effective dates, there is no additional *control* recommendations related to this item.

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Recommendation #2: SDCERS' staff should correct all underpriced PSC [10]contracts identified.

[7] Member contribution rates are used by IRIS in a variety of ways, including verifying Member contributions withheld by the Plan Sponsors and remitted to SDCERS are accurate. IRIS has a validation check to determine if a Member's contribution to SDCERS is equal to his/her pensionable salary multiplied by his/her contribution rate less any offset (if applicable).

[8] Currently, SDCERS' staff does not upload new Member contribution rates until all Plan Sponsor transmittal files for the prior fiscal year are received.

[9] It is anticipated that the production version of IRIS will contain multiple Member contribution Tables in 2018.

[10] There were no PSC contracts created in July 2017, before the new 2018 Member contribution rates were updated, that would impact a PSC contract calculation.

Finding #3: PSC contracts are not expiring after 60 days as required by Board Rule 4.30.

Priority Rating: Medium

The cost of a PSC contract, eligible payment options, contract expiration date and a signature line are included on a PSC contract. PSC contracts are created in IRIS. Per Board Rule 4.30, the quoted price provided in a PSC contract is guaranteed for a period of no longer than 60 days from the date of the PSC contract calculation.[11] A Member must return to SDCERS the signed PSC contract within the 60 day deadline for it to be valid under Board Rule 4.30.

SDCERS has programmed IRIS to automatically void a PSC contract at 12:01 am on the 63rd day after the contract is calculated.[12] IRIS was intentionally programmed this way to provide staff processing time. This allows a Member to turn in a signed PSC contract on the 60th day, and gives staff until the 63rd day to complete the process, before IRIS automatically voids the contract.

The date on the PSC contracts that are mailed to Members, however, indicates the contract expires on the 63rd day instead of the 60th day as required in Board Rule 4.30. This error eliminates staff's processing time and incorrectly indicates that the PSC contract is valid for 63 days. Additionally, since IRIS has been programmed to automatically void a contract at 12:01am on the 63rd day, any contract turned in on the 63rd day, has already been voided in IRIS.

Six of the 25 PSC contracts selected for testing were turned in after the 60 day deadline but before the 63rd day indicated on the PSC contract. Three of those contracts were received by SDCERS on the 63rd day and staff had to manually recreate the contract to honor the amounts and dates included in the PSC contract because IRIS had already voided these contracts.

[11] The passage of time, in most cases, increases the cost of a PSC contract as the Member has more service credit.

[12] If a Member has multiple contracts available (e.g., a Long Term Disability contract and Leave without pay contract) and the Member decides to purchase the PSC contract for the Long Term Disability contract, IRIS does not void the Leave without pay contract after the 63rd day. IRIS currently does not have the functionality to separately identify each PSC contract (i.e., IRIS will either void all contracts or none).

Finding #3 (Continued): PSC contracts are not expiring after 60 days as required by Board Rule 4.30.
Priority Rating: Medium

Those three manually recreated contracts contained allocation errors due to staff using an incorrect allocation percentage.[13] In general, a Member's contribution is allocated to the Normal Cost, Cost of Living (COL) Annuity, and Surviving Spouse or Domestic Partner (Surviving Spouse) contribution accounts.[14] The calculation variances for the three Members are shown below.

	Normal Cost	COL Annuity	Surviving Spouse	Total
Member #1				
As Calculated	$73,325.65	$5,156.15	$2,335.62	$80,817.42
Correct	$73,251.98	$5,204.23	$2,361.21	$80,817.42
Variance	**$73.67**	**$(48.08)**	**$(25.59)**	$-
Member #2				
As Calculated	$40,676.01	$2,634.88	$1,197.27	$44,508.16
Correct	$40,620.59	$2,674.24	$1,213.33	$44,508.16
Variance	**$55.42**	**$(39.36)**	**$(16.06)**	$-
Member #3				
As Calculated	$2,604.32	$106.50	$48.28	$2,759.10
Correct	$2,589.74	$116.50	$52.86	$2,759.10
Variance	**$14.58**	**$(10.00)**	**$(4.58)**	$-

Recommendation #3a: IRIS should be reprogrammed to show the expiration date on a PSC contract is 60 days after the contract is calculated.

Recommendation #3b: The Board should consider options to address this finding which could include, but are not limited to:
1) Waiving Board Rule 4.30's 60 day expiration date requirement, and increase it to 63 days, for all PSC contracts that indicated the Member had 63 days to sign and return the PSC contract to SDCERS, or
2) Direct staff to recalculate all PSC contracts that were signed and returned to SDCERS after the 60 day deadline.

Recommendation #3c: SDCERS' staff should reallocate the contribution accounts for the Members identified above.

[13] The allocation error occurred because staff was using the IRIS allocation amounts as it related to the Total Member Cost of the contract. The Total Member Cost includes Employee and Employer costs. Because the COL Annuity and SS contributions are only paid by the Employee the allocation percentages of the Total Member Cost are incorrect if staff overrides the Cost of a contract to equal anything other than the Total Member Cost amount. These three Members are "Active" and do not require any retirement benefit change.

[14] The COL Annuity and SS Annuity retirement benefits are dependent on a Member's accumulated contributions at retirement.

Finding #4: For two Members, payment was not completed within 60 days of signing the proposed PSC contract as required by Board Rule 4.30.

Priority Rating: Medium

Board Rule 4.30 states payment must be completed within 60 days of the date the Member signs the proposed PSC contract. For two Members selected for testing their PSC contracts were paid for after the 60 day deadline.

Member #1 submitted all of her paperwork prior to the 60 day deadline; however she did not have sufficient pre-tax funds in one of her accounts to purchase the PSC contract. SDCERS' staff worked with this Member and the Member arranged to use other pre-tax funds to complete the purchase. The date on the check was on the 60th day; however SDCERS did not receive and process her payment until the 66th day.

Member #2 submitted all of her paperwork prior to the 60 day deadline; however SDCERS did not receive and process her payment until the 77th day.

For both Members the deadline was exceeded. SDCERS' staff, however, was working with the Members to complete their purchase prior to the deadline. In both instances, there was evidence the Members were making good faith efforts to complete these purchases within the 60 day deadline. There is no Board Rule or process improvement that can address unforeseen circumstances that are experienced by staff when trying to complete a PSC contract (e.g., changes in the market value of Member assets, processing time by the Member's financial institution, and mailing time).

Recommendation #4: SDCERS management should consider options to address this finding which could include, but are not limited to:

1) Clarify Board Rule 4.30 to require all *paperwork* be completed by the Member and returned to SDCERS within the 60 day deadline instead of when *payment* is received,
2) Request the Board waive Board Rule 4.30 for instances when the Member completes all paperwork prior to the 60 day deadline but payment is received after the 60 day deadline, or
3) Refund all PSC contracts where payment was accepted after the 60 day deadline.

Finding #5: One PSC contract incorrectly used the General Member contribution rate instead of the Safety Member contribution rate. This error caused the PSC contract to be underpriced.

Priority Rating: Medium

In general, a PSC contract is based on a Member's age, contribution rate, years of service and highest annual pensionable salary at the time the PSC contract is calculated. Additionally, a Member's contribution rate is based on the age they became an SDCERS Member and the Plan they contribute to (e.g., Safety, General).

One PSC contract selected for testing incorrectly used the General Member contribution rate instead of the Safety Member rate on a "Recruit Time" PSC contract. This caused the PSC contract to be underpriced by $2,663.98. The General Member contribution rate was inadvertently used because IRIS automatically populated the PSC rate using her current General Member rate even though she has both General and Safety membership. The reviewer inadvertently missed this during the quality control process.

Recommendation 5a: The PSC contract for the Member identified above should be corrected.

Recommendation 5b: SDCERS' staff should be alert when calculating a PSC contract for a Member when they have more than one Plan type (e.g., Safety, General).

Finding #6: Board Rule 4.40 does not instruct staff on how to allocate repaid contributions to a Member's Normal, COL Annuity and SS contribution accounts.

Priority Rating: Low

PSC Contract Allocation

Board Rule 4.40 states, "A Member who is re-employed by the City or the Airport Authority may repay the contributions the System previously refunded to the Member, plus interest at the actuarial interest rate, under the rules and procedures established by the System." Board Rule 4.40 does not, however, instruct staff on how to allocate repaid contributions to the Normal, COL Annuity and SS contribution accounts.

In 1986, the City increased Members' COL Annuity contributions from 15% to 20%, of the sum of a Member's Normal plus SS contribution amounts. This is the current percentage that is allocated to a Member's COL Annuity account.

One Member selected for testing, requested his contributions of $16,898.23 to be refunded in 1997 when he left City employment. This Member was making COL Annuity contributions at both the 15% and 20% amounts. The Member's contribution accounts at the time of refund are shown below.

Member's Allocation when Refunded	
Contribution Account	**Amount**
Normal	$13,048.26
COL Annuity	2,547.46
SS	1,302.51
Total	$16,898.23

This Member was subsequently re-employed by the City. In 2016, this Member submitted a PSC contract to repay these contributions at a cost of $61,741.77. Because Board Rule 4.40 does not instruct SDCERS how to allocate the repaid contributions, there are several reasonable ways the repaid contributions could be allocated. The chart below shows the $61,741.77 if it were allocated based on the actual amount refunded with interest and if it were allocated based on the current allocation percentages. SDCERS staff allocates repayments based on the current allocation percentages.

Repayment Allocations					
Contribution Account	**Actual Refund**	**Interest**	**Actual Refund plus Interest**	**Based on current allocation percentages**	**Difference**
Normal	$13,048.26	$39,259.72	$52,307.98	$51,327.94	$980.04
COL Annuity	2,547.46	7,664.82	10,212.28	11,292.55	(1,080.27)
SS	1,302.51	3,919.00	5,221.51	5,121.28	100.23
Total	$16,898.23	$50,843.54	$67,741.77	$67,741.77	$-

The COL Annuity retirement benefit is dependent on a Member's accumulated contributions at retirement. Therefore the method of allocating a Member's previously refunded contributions can impact the benefit they would receive in retirement.[15] While both methods are reasonable, using the current allocation percentages provides a larger retirement benefit than the Member would have received if he/she would have left their contributions with SDCERS. It is unknown if this is the intention of the Board.

[15] The amounts allocated to a Member's SS account can also impact a Member retirement benefit. The identified Member is not impacted because the Member did not select a benefit that allows him to collect a SS Annuity at retirement. This Member is also in DROP and has not received any retirement benefits.

Finding #6 (Continued): Board Rule 4.40 does not instruct staff on how to allocate repaid contributions to a Member's Normal, COL Annuity and SS contribution accounts.

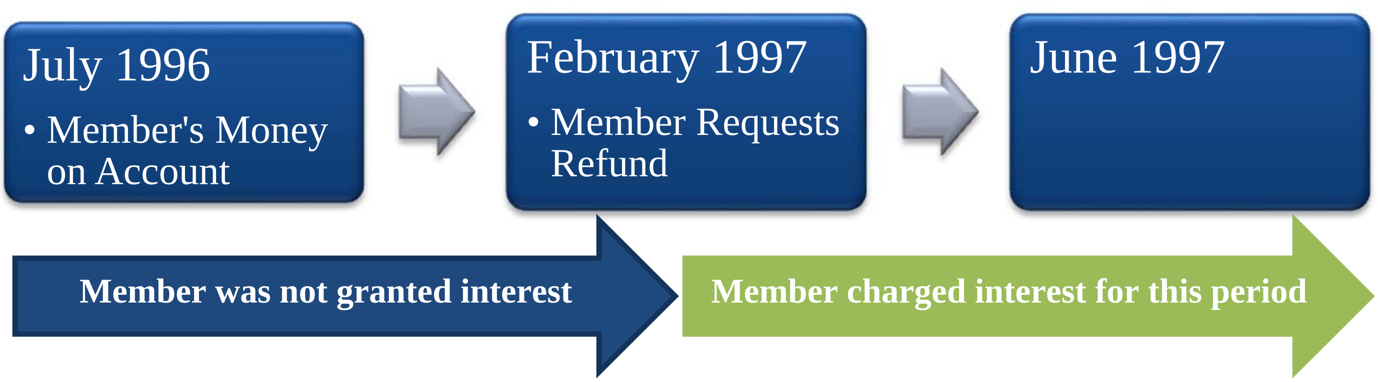
Priority Rating: Low

Based on a review of IRIS, this is the only impacted Member during the scope of this audit. This allocation only impacts Members who request PSC contracts and were making contributions prior to July 1, 1986, or over 31 years ago, and is very unlikely.[16] For this reason, and because both methods identified above are reasonable, I am not making any additional *control* recommendations.

PSC Contract Calculation

The Board credits interest to Member accounts based on contribution amounts as of June 30 of the current year. There is no provision to prorate interest to Member accounts.

The IRIS recalculated PSC contract of $67,741.77 (noted above) is based on the refunded amount of $16,898.23 plus interest compounded each year, which is based on the actuarial interest rate. The actuarial interest rate in 1997 was 8.0%. SDCERS used 8% for 1997; however, the 8% was prorated for the days from February 1997 (when the Member's money was initially refunded) to June 1997 (end of fiscal year when interest is credited to Member accounts). SDCERS staff feels charging 8% for the entire year, without prorating it, would be inappropriate because the Member had contributions on account from July 1996 to February 1997, and the System was earning income on those funds but the Member was not granted interest. Therefore, staff believes charging him interest for the full year when he was not granted interest for part of the year is inappropriate. See below for a timeline.



While this interpretation is reasonable there is no provision in the Board Rules or Plan Documents to calculate a refunded PSC contract with prorated interest. The Plan also does not prohibit prorating interest as described above, and for this reason the Internal Auditor does not have any specific recommendations related to the PSC contract calculation.

Recommendation #6: SDCERS' staff should consider clarifying Board Rule 4.40 to include direction on how to allocate repaid contributions to a Member's Normal, COL Annuity, and SS Contribution accounts.

[16] Management represents that certain prior PSC contracts, not within the scope of this audit, have also used the current allocation percentages and would be impacted.

Finding #7: One Deferred Member completed PSC contracts. Board Rule 4.00 states that Deferred Members are not eligible to purchase service credit.

Priority Rating: Low

Board Rule 4.00 states Deferred Members are not eligible to purchase service credit while on deferred status.[17] A Deferred Member is a Member who leaves his or her contributions on deposit with SDCERS after terminating service. One Member selected for testing completed her PSC contract while on deferred status. This occurred because the City did not communicate to SDCERS that she was on deferred status until after the PSC contract was completed. The timeline below provides details on how this occurred.

Active	10/9/2015	• Member Requests PSC
Active	10/12/15	• Member terminates (SDCERS not informed) - See 2/6/16
Deferred	10/31/15	• Member Requests to be placed on Special Leave Without Pay (a Deferred Status) retroactive to 10/12/15
Deferred	11/18/15	• Member signs intent to Purchase
Deferred	12/24/15	• City changes Member status to Deferred effective 10/12/15
Deferred	2/4/16	• PSC contract paid in full
Deferred	2/6/16	• Member submits resignation - which was effective 10/12/15
Deferred	2/29/16	• SDCERS informed by City that Member Terminated 10/12/15

The Internal Auditor discussed this matter with staff. SDCERS' General Counsel determined this Member's PSC contract is valid and should not be voided because SDCERS' staff did not properly counsel this Member on her ability to purchase a PSC contract while on Special Leave Without Pay. Because SDCERS' staff always attempts to fully inform Members of the benefits available the Internal Auditor does not have any recommendations for this finding.

Recommendation 7: Not Applicable.

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[17] Also, SDMC §24.1301 states, "Deferred Members who have left their contributions on deposit with the Retirement System are not eligible to make purchases of service credit in the Retirement System while on Deferred Status."

Finding #8: For two Members, SDCERS incorrectly indicated pre-tax or post-tax money was used to pay for a PSC contract.

Priority Rating: Low

Member #1 transferred $51,737.64 of pre-tax contributions to SDCERS for payment on a PSC contract. IRIS, however, indicates these contributions are post-tax.

Member #2, who is a grandfathered Member, transferred $941.14 of post-tax contributions to SDCERS for payment on a PSC contract. IRIS, however, indicates these contributions are pre-tax.

In most cases, the taxable portion of a Member's retirement benefit depends on the amount of pre-tax and post-tax contributions made by the Member. Incorrectly indicating contributions as pre-tax or post tax would result in incorrect 1099-R reporting to the Internal Revenue Service.

Recommendation 8: SDCERS' staff should change the Member accounts identified above to properly reflect the method of payment made (pre-tax vs. post-tax).

INHERENT LIMITATIONS

Because of the inherent limitations of internal controls and because samples were selected, errors or irregularities may occur and may not be detected. Also, projections of any evaluation of the internal control structure to future periods are subject to the risk that procedures may become inadequate due to changes in conditions, or that the degree of compliance with the procedures may deteriorate.

CONCLUSION

The objective of the audit was to evaluate the operational controls used to setup and calculate PSC contracts and verify the accuracy of transactions. Based on the audit work performed, I have concluded the following:

SDCERS has excellent controls in place to correctly calculate PSC contracts and most of these controls have been built into IRIS. Because of the diligent work performed by staff and the controls in place, 99.35% of the costs of all PSC contracts tested were correctly calculated.[18] PSC contract controls, however, could be strengthened by implementing the recommendations contained in this report.

[18] Based on audit sample.

APPENDIX A - AUDIT OBJECTIVES, SCOPE & METHODOLOGY

AUDIT OBJECTIVES

The objective of the audit was to evaluate the operational controls used to setup and calculate PSC contracts and to verify the accuracy of transactions.

AUDIT SCOPE & METHODOLOGY

This audit was performed for the period from July 1, 2015 through December 31, 2016 by using the following methods:

- Reviewed the Plan, Board Rules, Legal Opinions, SDCERS 2016 Comprehensive Annual Financial Report, Public Employees' Pension Reform Act (PEPRA), Internal Revenue Service 415 Limits, the Uniformed Services Employment and Reemployment Act of 1994 (USERRA), and the SDCERS Participation and Administration Agreement.
- Reviewed policies and procedures utilized by staff to process to process PSC contracts.
- Interviewed staff responsible for processing PSC contracts.
- Randomly selected 25 completed PSC contracts. For each contract selected:
    - Recalculate the cost of the PSC contract.
    - Determine:
        - If there are USERRA, PEPRA or 415 limit implications
        - If the time is purchasable
        - If the Member completed the PSC contract within the time periods allowed
        - If the Normal, COL Annuity, and Surviving Spouse contribution allocations is correct
        - If the money received from the Member was deposited timely
        - If IRIS correctly classifies the payment on PSC contracts as pre-tax or post-tax.
- Determine if any PSC contracts purchased by Airport Members hired after October 2, 2006, Port Members hired after October 1, 2005, and City Members hired after July 1, 2005 were five year contracts and if those contracts were allowable.
- Determine if all completed or in-progress five year contracts for Airport and Port Members, with a contract date greater than January 1, 2013, are allowable.
- Determine, for PSC contracts terminated between July 1, 2015 and December 31, 2016, if the Member's account accurately reflects the amounts received.
- Determine if the price difference between a five year PSC contract and a two and three year contract is reasonable.
- Reconcile PSC contracts receivable per IRIS to the General Ledger as of June 30, 2016 and December 31, 2016.

This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*. Those standards require that Internal Audit plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. Internal Audit believes the evidence obtained provides a reasonable basis for the findings and recommendations.