An Opinion Audit on the

Office of the Fire Fighters' Pension Commissioner

Office of the State Auditor
Lawrence F. Alwin, CPA

April 1995

Report No. 95-113

Key Points Of Report

An Opinion Audit on the Office of the Fire Fighters' Pension Commissioner

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Key Facts And Findings

- As of the year ended August 31, 1994, the Fire Fighters' Relief and Retirement Fund had total assets of $15.6 million and paid out approximately $720,000 in retirement benefits.
- Our consideration of the internal accounting controls related to the control environment, investments, cash disbursements, and cash receipts disclosed no reportable conditions that involve a material weakness. Subsequently, other financial analysis and review indicated that the financial statements are free from material misstatement, and the Commission complied, in all material respects, with laws and regulations.
- The Commission deviated from its procedures for processing cash receipts for a period of three months due to staff vacancy. While the deviation from procedures was only for a short period, any deviation from established internal control procedures creates a risk that errors, mistakes, and/or fraud may occur and not be detected in a timely manner.
- Documentation showing that reconciling items for investments are properly identified and investigated was not prepared. In addition, an income-anticipation schedule to accurately forecast dividends revenues due is not used. These two omissions relating to investment accounting increase the risk that material misstatements, errors, and omissions can occur and not be detected in a timely manner.
- The improper accounting and reporting of certain expenditures related to professional fees, FICA liabilities, cash in State Treasury, and the use of straight-line instead of the effective interest method of amortization for discounts and premiums could lead to material misstatements in the financial statements.

Contact:

Barbara S. Hankins, CPA, Audit Manager (479-4921)

This financial/compliance audit (opinion audit) was conducted in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States.

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LAWRENCE F. ALWIN, CPA
State Auditor

SHARON W. COBB, CPA
First Assistant

April 5, 1995

Members of the Legislative Audit Committee:

The fiscal year 1994 component unit financial statements of the Fire Fighters' Pension Commissioner are in compliance with generally accepted accounting principles and are correct in all material respects. However, we identified certain areas which could be improved related to internal controls and the accounting and reporting of certain financial transactions.

Although these areas for improvement do not constitute a material weakness, they are considered significant to the operation of the Commission.

- There were few internal controls over cash receipts.
- Investments were not properly accounted for and reported.
- Certain transactions reported in the financial statements were misstated.

Our examination was conducted in connection with the statewide financial and compliance audit for fiscal year ended August 31, 1994. The information in this report will be referred to the statewide audit report.

Management of the Commission concurs with the recommendations in this report. We appreciate the courtesy and cooperation of management during the course of this audit.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

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Detailed Issues and Recommendations

With respect to the items tested, the Commission has complied in all material respects with generally accepted accounting principles, applicable laws, and regulations and maintains a system of internal controls. With respect to the items not tested, we have no reason to believe that the Commission did not comply with these principles. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. These are discussed below.

Section 1:

Improve Internal Controls Over Cash Receipts

The Commission engaged two employees to perform the mail-opening functions. The duties of these employees also included recording of transactions into the accounting system (USAS), preparing deposit slips, and depositing receipts. Generally accepted auditing standards suggest that employees who perform accounting and record keeping functions should not be allowed access to or custody of those assets.

During the three-month period beginning October 1994 when the Commission had alternate employees to perform the mail-opening functions, the following occurred:

- Inadequate segregation of duties existed.
- The Commission's internal control policy to log cash receipts and generate a summary spreadsheets was not performed.

When proper controls are not in place, there is a possibility that errors, mistakes, or fraud can occur and not be detected on a timely basis by employees while performing their assigned functions.

<u>Recommendation</u>: We recommend that the Commission segregate the duties related to cash receipts and continue to observe its policies and procedures related to the logging of cash receipts.

<u>Management's Response</u>: There are times in a small agency, with a staff of five people, that certain functions are difficult to perform in a timely manner. When that number of people are decreased by one, some things go undone.

Certainly the Commission is cognizant of the need for control in the area of cash receipts and plans to continue to follow the established policies and procedures related to logging of cash receipts.

Section 2:

Improve Accounting and Reporting of the Commission's Investments Portfolio

We noted several areas relating to the investments portfolio where the Commission can improve in order to properly account and report its investment activities. These include:

- **Reconciliation**: Reconciling items in the reconciliations of the Commission's investment portfolio were not properly identified and investigated, reconciling items noted as a timing-difference could not be traced to subsequent custodian statements, and the amount noted as "bond amortization" in the Commission's monthly reconciliation of $267,371.89 differs from the amortization reported in the investment records as $32,693.29. There was no documentation showing that the Commission reconciles to the amortization schedule. As a result, the audit trail between the investment balances reported by the Commission and the custodian was distorted.

- **Income-anticipation Schedule**: The Commission does not have an income anticipation system to accurately forecast the amount of dividend revenues due for all equity securities. As a result, the Commission only records dividends as received and cannot determine, in advance, the amount of dividends due and whether or not all dividend revenues have been received.

- **Amortization of Premiums and Discounts**: The Commission is using the straight-line instead of the effective interest method of amortization for discounts and premiums. Generally accepted accounting principles require all public employee retirement systems (PERS) and other entities using pension accounting to report investments in fixed-income securities at amortized cost using the effective interest method of amortization. The use of straight-line as opposed to the effective interest method of amortization can result in different amounts charged as monthly amortization and carrying balances of investments in fixed-income securities.

Recommendation: We recommend that the Commission improve its accounting and reporting of investments by properly documenting and investigating reconciling items, developing an income-anticipation schedule so that it can properly forecast investment dividends due, and using the effective interest method of amortization of discounts and premiums for investments in accordance with generally accepted accounting principles.

Management's Response: Management will ensure that all reconciliations are thoroughly documented in FY 1995 in order to provide a clear audit trail.

Management will implement an income anticipation schedule before the end of FY 1995 and will also utilize the effective interest method of amortization for discounts and premiums of fixed-income securities for FY 1995 in accordance with your recommendations.

Section 3:
Improve Accounting and Reporting of the Commission's Financial Statements

We noted several areas where the Commission can improve the accounting and reporting of its financial transactions:

- Improper accounting and reporting of certain professional services occurred during fiscal year 1994. Proper accounting for these transactions will reduce the risk that there could be material misstatements in the financial statements.

- FICA liability is not consistently calculated properly and reported, resulting in understatement of FICA liability.

- In reconciling the cash in State Treasury, the ending balance **before** adjustments was used as the beginning balance for the follow month's reconciliation, instead of the ending balance **after** adjustments. Secondly, there was no documentation showing that the individual reconciling items were determined or investigated. As a result, the necessary audit trail is distorted, and the reconciling items could not be traced to subsequent statements.

Proper accounting and reporting of the Commission's activities cannot be achieved when expenditures and cash in State Treasury are not properly accounted for and reported in the financial statements.

Recommendation: We recommend that the Commission improve its accounting and reporting of the financial statements by properly accounting and reporting all professional fees, considering all the variables necessary to properly calculate FICA liabilities, and using ending cash balance **after** adjustments as the beginning balance for subsequent reconciliations.

Management's Response: We agree that $9,250 in professional services were not accrued properly at the end of the fiscal year. We will implement revised procedures to ensure that such fees are properly accrued in the future.

We concur that there was an understatement of FICA liability. The problem has been corrected and revised procedures implemented which include review of all payroll transactions by the CPA.

The procedures for reconciliations with the Treasury involve the following steps. The Treasury Journal and DAFR 8660 are reconciled each month. There are reconciling items because the DAFR 8660 does not always reflect all vouchers that have been written. These vouchers are written as reconciling items on the DAFR by number and amount and the DAFR 8660 is reconciled with the Treasury Journal. The DAFR for the previous month is used for reconciliation purposes in balancing the current month transactions.

The ending DAFR 8660 balance is always reconciled with the Treasury Journal balances and the Treasury Journal balances have never been incorrect. We believe this process is a proper reconciliation of cash in the State Treasury. We do concur with your finding that although the reconciliation process is correct, the Commission needs to provide better documentation of its reconciliation process. This procedure is currently in place.

Appendix 1:

Objective, Scope, and Methodology

Objective

Our objective was to accomplish the following:

- Perform a financial audit in order to express an opinion on the fiscal year 1994 financial statements in accordance with generally accepted auditing standards and *Government Auditing Standards*.
- Review and evaluate significant internal controls.
- Provide the Commissioner with a management letter.
- Design audit procedures to provide reasonable assurance of detecting material errors or irregularities and be alert for areas of waste, fraud, and abuse.
- Verify compliance with laws and regulations that may have a material effect on the Commissioner's financial statements.
- Be alert to high-risk or other important issues outside our audit scope that would be appropriate for input to the State Auditor's Office Risk Ranking System.
- Update permanent file information to comply with new standards developed by the State Auditor's Office.
- Evaluate the status of prior year findings that have a significant impact upon other audit objectives. Prior year findings related to lack of disaster recovery system and back-up procedures for certain reports and records related to annuitants.

Scope

The scope included consideration of the following:

- Internal control structures over cash receipts, cash disbursements, and investments.
- Compliance with laws and regulations that could have a material effect on the financial statements.
- Financial statements reporting.
- Accuracy in reporting of selected accounts, including investments of $14.7 million, revenues of $2.4 million, and expenditures of $1.5 million. Other tests of selected account balances included cash, fund balance, fixed assets, and compensatory leave balances.

Methodology

The methodology used during our audit consisted of collecting and analyzing basic financial information, performing fluctuation analyses of account balances shown on the financial statements, reviewing the accuracy of the overall financial statements, reviewing prior year management letter comments, gaining an understanding of the internal control structure of selected material accounts, and performing tests of details on cash, revenues, expenditures, investments, compensable leave, fixed assets, and fund balance. We also tested for compliance with GASB 3 and GASB 5.

Other Information

Fieldwork was conducted from December 1994 through January 1995. The audit was conducted in accordance with applicable professional standards, including:

- generally accepted government auditing standards
- generally accepted auditing standards

The audit work was performed by the following members of the State Auditor's Office staff:

- C.Y. Ihekwoaba, CPA, CFE (Project Manager)
- Ed Pyun, CPA
- Barbara S. Hankins, CPA (Audit Manager)
- Deborah Kerr, Ph.D. (Director)

Appendix 2:

Agency Profile

The Fire Fighters' Pension Commissioner was created to administer the Fire Fighters Relief and Retirement Fund, a cost-sharing multiple employer pension system. This Fund was created by Senate Bill 411, 65th Legislature, RS, in 1977, along with the applicable benefit provisions. The Fire Fighters Relief Fund is considered a component unit of the State of Texas for financial reporting purposes and is included in the State's financial reports as a pension trust fund. The Commission is involved in the following two retirement programs:

1. The Statewide Volunteer Fire Fighters Retirement Act - Article 6243.e3 (SB 411). This fund is the focus of our audit. Funds from participating volunteer departments are pooled in one fund and managed by the Commission in an actuarially sound retirement fund. As of August 1993, the fund had assets of about $15 million with 141 member departments. The agency mails about 1,500 annuitant checks monthly. The primary function of the Commission is to ensure that pension funds for fire fighters are actuarially sound and that their members receive the benefits to which they are entitled.

2. The Texas Local Fire Fighters Retirement Act (TLFFRA) - Article 6243.e. Our audit does not cover this fund. As of August 1992, there were 163 departments participating in TLFFRA. Of that number, 37 are fully paid departments, five are part paid, and 121 are volunteer. There are 6,613 participating fire fighters. Total assets are $344 million. The funds are held locally by a local board of trustees whose duties is to interpret the laws, maintain records of all participants, review annual reports, and prepare an annual report to the Governor.

During the last quarter of fiscal year 1994, the Commission employed five full-time equivalent employees. The governing bodies of the plan members are required to contribute at least $12 per month for each member. Additional contributions may be necessary to pay for unfunded prior service cost and "buybacks" of vested benefits as though SB 411 had been in effect for 15 years of service at age 55 for volunteer fire fighters. The State may also be required to make a limited amount of annual contributions to make the fund actuarially sound. To date, no contributions have been required from the State.

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Appendix 3:

Auditor's Report on Compliance with Laws and Regulations Material to the Component Unit Financial Statements

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State Auditor

SHARON W. COBB, CPA
First Assistant

Auditor's Report on Compliance with Laws and Regulations Material to the Component Unit Financial Statements

January 28, 1995

Board of Trustees
Office of the Fire Fighters' Pension Commissioner

Members of the Board:

We have audited the component unit financial statements of the Office of the Fire Fighters' Pension Commissioner as of and for the year ended August 31, 1994, and have issued our report thereon dated January 28, 1995.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the component unit financial statements are free from material misstatement.

Compliance with laws and regulations is the responsibility of management. As part of obtaining reasonable assurance about whether the component unit financial statements are free from material misstatement, we performed tests of the Commissioner's compliance with certain provisions of laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, the Commissioner complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to the items not tested, nothing came to our attention that caused us to believe that the Commissioner had not complied, in all material respects, with those provisions.

This report is intended for the use of the Commissioner's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

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Appendix 4:

Auditor's Report on Internal Controls

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Auditor's Report on Internal Controls

January 28, 1995

Board of Trustees
Office of the Fire Fighters' Pension Commissioner

Members of the Board:

We have audited the component unit financial statements of the Fire Fighters' Pension Commissioner as of and for the year ended August 31, 1994, and have issued our report thereon dated January 28, 1995.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the component unit financial statements are free from material misstatement.

In planning and performing our audit for the year ended August 31, 1994, we considered the Commissioner's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the Commissioner's component unit financial statements and not to provide assurance on the internal control structure.

Management is responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization, and recorded properly to permit the preparation of component unit financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

Internal Accounting Controls

- Control environment
- Investments
- Cash disbursements
- Cash receipts

For all the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation. We also assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Commissioner's ability to record, process, summarize, and report financial data consistent with the assertions of management in the component unit financial statements. The detailed findings relating to these reportable conditions are included in the agency's management letter in the Detailed Issues and Recommendations section of this report.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the component unit financial statements being audited or that noncompliance with laws and regulations may occur and not be detected by management within a timely period in the normal course of operations.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended for the use of the Commissioner's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

Copies of this report have been distributed to the following:

Legislative Audit Committee

Honorable Pete Laney, Speaker of the House, Chair
Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
Representative Robert Junell, Chair, House Appropriations Committee
Representative Tom Craddick, Chair, House Ways and Means Committee

Governor of Texas

Honorable George W. Bush

Legislative Budget Office

Sunset Advisory Commission

Office of the Fire Fighters' Pension Commissioner

Ms. Helen Campbell, Commissioner

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