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

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April 1996

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# Key Points Of Report

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

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April 1996

### Overall Conclusion

The fiscal year 1995 general purpose financial statements of the Office of the Fire Fighters' Pension Commission, a component unit of the State of Texas, are accurately presented in all material respects, in accordance with generally accepted accounting principles. However, we identified certain areas which could be improved related to internal controls and the accounting and reporting of certain financial transactions.

### Key Facts And Findings

- As of the fiscal year ended August 31, 1995, the Fire Fighters' Relief and Retirement Fund had total assets of \$16.5 million and paid out approximately \$820,000 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.
- Internal controls over a new arrangement for contracted investment services are not sufficient to mitigate the appearance of conflict of interest. Investment managers should report investment activities directly to the Commission and not through other parties. The Commission should obtain data necessary to perform complete reconciliations of investment managers' and custodian's activities. The Commission should have on-line access to their subaccount at the Depository Trust Corporation to verify transactions.
- The Commission receives one quarterly billing from the investment consultant for all contracted investment services. The billing detail does not itemize each service and allocate the "wrapped" fee to each service. As a result, the Commission cannot accurately account for its contracted investment services. In fiscal year 1995, \$41,676 of professional service fees were included in calculating net gain on disposition of investments due to inadequate billing detail.

### Contact

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## Office of the State Auditor

Lawrence F. Alwin, CPA

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

# Key Points Of Report

## Office of the State Auditor

Lawrence F. Alwin, CPA

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

Section 1:

## Implement Recommended Internal Controls over Investments to Mitigate the Appearance of Conflict of Interest

The Commission has not implemented recommended internal controls over investments to mitigate the appearance of conflict of interest over its contracted investment services. The Commission has entered into a “wrapped” fee contract in which one firm performs the following investment services for the Commission:

- custodian
- investment consulting
- assisting in the evaluation, selection, and retention of investment managers
- direct payments to the investment managers
- broker (at the investment managers’ discretion)

In a September 30, 1993, letter from the State Auditor’s Office to the Commission, we advised the Commission that while there is no direct conflict of interest in such a relationship, such a relationship may reduce internal controls over investment transactions. We further advised the Commission of recommended internal controls over investment transactions which should be in place to mitigate the appearance of conflict of interest. At the time of our audit, the following recommended internal controls were not in place:

**Investment managers should report investment activities directly to the Commission and not through other parties.** Two of the Commission’s three investment managers do not report investment activity directly to the Commission. The Commission’s only source of investment activity information for these two investment managers is the Custodian/Consultant.

**The Commission should actively monitor the investment managers’ and custodian’s activities through reconciliations.** The Commission is not receiving the data necessary to perform complete reconciliations of the investment managers’ and custodian’s activities.

**The Commission should have on-line access to their subaccount maintained at the Depository Trust Corporation to verify transactions daily with the Custodian.** The Commission does not have on-line access to verify transactions daily.

Recommendation:

We recommend that the Commission implement the recommended internal controls over investments immediately to mitigate the appearance of conflict of interest in contracted investment services.

Management's Response:

*When the Commission began considering the flat fee concept for the pension fund, we, along with our consultant, actively sought the assistance and guidance from the State Auditor's Office. These original discussions took place in 1993. The concept has been studied in detail for the past two to three years and the flat fee account became effective September 1, 1995 for fiscal year 1996. The Commission and the consultant have been sensitive to this transition period and have striven to refine all issues that have arisen.*

*During this transition period of transferring assets from one custodian to another, there have been some transfer and transitional disruptions that the auditors have properly noted. The transitional items have been well known to the Commission and the consultant and there has been and is an ongoing dialogue to address and solve all of these issues. One investment manager did not continue sending individualized reports to the Commission under the belief that no additional reporting was required. They have been instructed to correct this and have agreed to do so. They will resume their reporting beginning with the month of March 1996. One other investment manager altered their format in order to provide the information required by the Commission. The remaining investment manager has continued to utilize the same reporting throughout the process.*

*During the transfer process the custodian/consultant notified the Commission that the bank had transferred data reflecting market value and cost at the same price. The internal controls of the Commission have maintained cost accounting and have continued to be accurate. The consultant has now completed their reconciliation process. Due to their strict internal controls, they were required to submit appropriate documentation and proofing of cost prior to receiving authority to have the cost accurately re-input into their computer system. This process has been lengthy, but is now at the completion stage. The Commission has reconciled to "cash" on a monthly basis. We will now be able to perform complete reconciliations as required by the auditor.*

*The Commission will conduct a study and ascertain the benefits of the auditors recommendation that we go on-line with the Depository Trust Corporation. We will begin this study immediately.*

*As always, the Commission will strive to put in place and improve internal controls to mitigate, evaluate, and determine any potential conflicts of interest among any of our suppliers.*

## Obtain Billing Detail Necessary to Accurately Account for Contracted Investment Services

The Commission does not receive adequate billing detail to accurately account for contracted investment services. The Commission entered into a new contract with its investment consultant to receive several investment services under one “wrapped” fee. In this arrangement, the investment consultant is also the Commission’s investment custodian and (at the discretion of the investment managers) a brokerage firm for trading in equity securities. The investment consultant makes direct payments to the investment managers on behalf of the Commission. The Commission receives one quarterly billing from the investment consultant for all contracted investment services.

To ensure accurate accounting for contracted investment services, the quarterly billing should itemize each service and allocate the “wrapped” fee to each service. Currently, billing detail does not itemize each service and allocate the “wrapped” fee to each service. As a result, the Commission cannot accurately account for its contracted investment services.

In fiscal year 1995, the Commission and the investment consultant operated under a different contractual arrangement. Again, billing detail was not adequate to accurately account for investment consultant and brokerage fees.

Investment consultant fees should be reported as professional services fees while brokerage fees are recognized as part of the cost of investment transactions. Inadequate billing detail resulted in no costs being reported in professional services fees for investment consultant services for fiscal year 1995. The \$41,676 in brokerage fees paid to the investment consultant as consultant fees were recognized as part of the cost of investment transactions. As a result, the professional services fees and net gain on disposition of investments reported in the Commission’s fiscal year 1995 annual financial report are incorrect.

### Recommendation:

We recommend the Commission obtain the billing detail necessary to accurately account for contracted investment services under the new contractual arrangement.

### Management’s Response:

*One of the reasons the Board entered into the flat fee arrangement with Dean Witter was in order to save money and still maintain adequate control. We believe that we have done that. The flat fee arrangement allows the investment managers to be paid according to the following schedule. The equity managers are paid on a 50 basis point arrangement and the fixed income manager on a 35 basis point arrangement.*

*To satisfy the concerns expressed by the auditors, a request has been made to Dean Witter to provide a hard copy billing to the Commission for approval prior to payment being made. This is acceptable and will be put into place immediately.*

*I have spoken with Mr.. Burt Fendleman from Dean Witter in New York who has informed me that there are no custodial charges for their clients. Mr.. Fendleman has stated that he is available to the auditors if there are any questions concerning this arrangement that he could assist in answering.*

*The Commission is in the process of obtaining the billing detail necessary to accurately account for all contracted investment services under the new arrangement.*

## 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 1995 financial statements in accordance with generally accepted auditing standards and *Government Auditing Standards*.
- Review and evaluate significant internal controls.
- Provide the Commission 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 Commission'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 improving internal controls over cash receipts and improving accounting and reporting of investment activities and certain financial transactions.

### 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 statement reporting
- Accuracy in reporting of selected accounts, including investments of \$15.8 million, revenues of \$2.3 million, and expenditures of \$1.3 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 February 1996 through March 1996. 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)
- Robin R. Key, CPA (Project Manager)
- Barbara S. Hankins, CPA (Audit Manager)
- Craig D. Kinton, CPA (Director)

## Agency Profile

The Fire Fighters' Pension Commission was created to administer the Fire Fighters Relief and Retirement Fund, a cost-sharing multiple employer pension system. This Fund was created by S.B. 411, 65th Legislature, R.S., 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 6243e.3 (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 1995, the fund had assets of about \$16 million with 144 member departments. The agency mails about 1,750 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 6243e. Our audit does not cover this fund. As of December 1994, there were 142 departments participating in TLFFRA. Of that number, 37 are fully paid departments, four are part paid, and 101 are volunteer. There are 6,695 participating fire fighters. Total assets are \$451 million. The funds are held locally by a local board of trustees whose duties are 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 1995, 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 S.B. 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 Internal Controls**

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# OFFICE OF THE STATE AUDITOR

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AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA  
State Auditor

## Auditor's Report on Internal Controls

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March 8, 1996

Board of Trustees  
Fire Fighters' Pension Commission

Members of the Board:

We have audited the general purpose financial statements of the Office of the Fire Fighters' Pension Commission, a component unit of the State of Texas, as of and for the year ended August 31, 1995, and have issued our report thereon dated March 8, 1996.

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 general purpose financial statements are free from material misstatement.

The management of the Commission 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 general purpose 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.

In planning and performing our audit of the general purpose financial statements of the Commission for the year ended August 31, 1995, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

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 Commission's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general purpose 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.

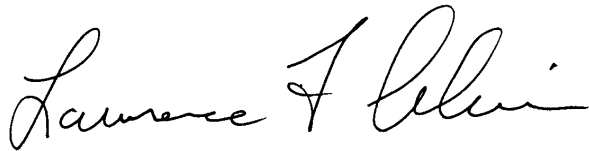
Board of Trustees  
Fire Fighters' Pension Commission  
March 8, 1996  
Page 2

A material weakness is a reportable condition in which the design or operation of one or more of the specific 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 general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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 information of the Commission's management and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in cursive script, reading "Lawrence F. Alwin".

Lawrence F. Alwin, CPA  
State Auditor

Appendix 4:

**Auditor's Report on Compliance with Laws and  
Regulations Material to the General Purpose Financial  
Statements**



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**OFFICE OF THE STATE AUDITOR**

TWO COMMODORE PLAZA  
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LAWRENCE F. ALWIN, CPA  
State Auditor

**Auditor's Report on Compliance with Laws and Regulations  
Material to the General Purpose Financial Statements**

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March 8, 1996

Board of Trustees  
Fire Fighters' Pension Commission

Members of the Board:

We have audited the general purpose financial statements of the Fire Fighters' Pension Commission, a component unit of the State of Texas, as of and for the year ended August 31, 1995, and have issued our report thereon dated March 8, 1996.

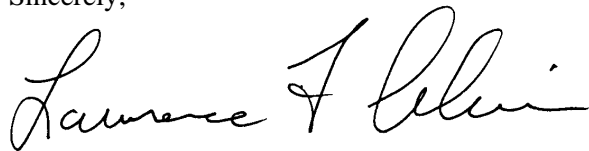
We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements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

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

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the Commission's management and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,



Lawrence F. Alwin, CPA  
State Auditor