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An Audit of the Financial Statements of the Office of the Fire Fighters' Pension Commissioner

October 1997

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Key Points of Report

An Audit of the Financial Statements of the Office of the Fire Fighters' Pension Commissioner

October 1997

Overall Conclusion

The Office of the Fire Fighters' Pension Commissioner's (Commission) general purpose financial statements for fiscal year 1996 are accurately presented in all material respects, in accordance with generally accepted accounting principles. We noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Additionally, in an October 1997 management control audit report, (SAO Report No. 98-003), we noted a material control environment weakness and one instance of noncompliance with depository law.

Key Facts And Findings

- At August 31, 1996, the Fire Fighters' Relief and Retirement Fund had total assets with a market value of $19.4 million and paid out approximately $910,000 in retirement benefits. There are 144 member fire departments participating in the pension system and 6,109 total members.

- The Commission did not implement three prior year recommendations relating to its investment portfolio. The Commission did not implement the recommendations due to its lack of controls over contracted investment services.

- The Commission could not obtain detail billing information under the "wrapped" fee arrangement for investment services, and the Commissioner's approval was not given for all payments.

- The Commission is operating without an effective income anticipation schedule to accurately forecast dividend and interest revenue. A material adjustment in the amount of $181,652 was needed to correct the prior years' reported accrual and revenue associated with investment interest income.

- Efficiency of operations can be achieved by using the audited fiscal year financial statements in the Commission's annual report to local departments.

Contact

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Office of the State Auditor

Lawrence F. Alwin, CPA

This financial 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:

The Commission Did Not Implement Recommended Internal Controls Over Investments to Mitigate the Appearance of Conflict of Interest

The Commission did not implement recommended internal controls over its $19.4 million (market value) investment portfolio. These controls are needed to mitigate the appearance of conflict of interest over its contracted investment services as reported in *An Opinion Audit on the Office of the Fire Fighters' Pension Commissioner* (SAO Report No. 96-062, April 1996). The Commission did not implement the three recommendations due to its lack of controls over contracted services of the Investment Managers and Investment Consultant/Custodian firm.

The Commission had a "wrapped" fee contract for its contracted investment services during fiscal year 1996. Under this contractual arrangement, one firm performed the following investment services for the Commission:

- Custodian
- Investment consulting
- Assistance in the evaluation, selection, and retention of investment managers
- Direct payments to the investment managers
- Broker (at the investment manager's discretion)

This contractual arrangement reduced internal controls over investment transactions and produced the appearance of a conflict of interest because the same firm was providing both custodial and investment consulting services. The Commission did not implement the following three recommended internal controls over investments to mitigate this appearance of conflict of interest:

- Investment managers should report investment activities directly to the Commission and not through other parties.
- The Commission should actively monitor the Investment Managers' and Custodian's activities through reconciliations.
- The Commission should have on-line access to its Depository Trust Corporation subaccount to verify transactions daily with the Custodian.

Section 1-A:

Investment Managers Should Report Investment Activities Directly to the Commission and Not Through Other Parties

The Commission's only source of investment information for two of its three Investment Managers continued to be its Investment Consultant/Custodian firm.

The Commission instructed the two Investment Managers to provide monthly investment reports to the Commission. These reports are necessary for the Commission to perform reconciliations of its investment portfolio. The Commission also agreed to a fee increase for one of the two Investment Managers to pay for these reports.

Within a month after the end of the fiscal year the Commission terminated the Investment Consultant/Custodian firm's "wrapped" fee arrangement. The Consultant assigned to the Commission's account left the firm and started his own company. On September 5, 1996, the Commission approved a contract with the Consultant's company, retained the same Investment Managers, and contracted with a new Custodian. (See SAO Report No. 98-003 for details.)

It appears that the Investment Managers did not start providing the monthly reports until after this new contractual arrangement was in place. It is not clear whether or not the Commission agreed to this delay.

Section 1-B:

The Commission Should Actively Monitor the Investment Managers' and Custodian's Activities Through Reconciliations

The Commission did not receive the data necessary to perform complete reconciliations of the dollar value of the portfolio during fiscal year 1996. The investment information provided under the Investment Consultant/Custodian firm's "wrapped" fee arrangement was presented in a format that was not comparable to the Commission's records. The investments were reported on a market-value basis rather than on a historical-cost basis. Additionally, this information was presented using the "First-In First-Out" method of accounting rather than the average cost method.

The Investment Consultant/Custodian firm was able to prepare comparable year-end reports to allow the Commission to prepare an annual reconciliation.

Section 1-C:

The Commission Should Have On-Line Access to Its Subaccount Maintained at the Depository Trust Corporation to Verify Transactions Daily With the Custodian

The Commission initially agreed to go on-line with the Depository Trust Corporation (DTC) at an additional cost of $500, plus the cost of the Contract Accountant's time to verify the transactions daily. However, in June 1996 the Commission decided that, instead of on-line access to DTC, it would use monthly reconciliations between the Investment Custodian's report, the Investment Managers' reports, and the Commission's investment accounting records as a compensating control.

This compensating control was not implemented because the Commission did not perform monthly reconciliations as discussed above.

The Commission terminated its "wrapped" fee arrangement with the Investment Consultant/Custodian firm on September 5, 1996. Internal controls over the new contractual arrangement are discussed in SAO's Report, *An Audit Report on Management Controls at the Office of the Fire Fighters' Pension Commissioner* (SAO Report No. 98-003).

Recommendation:

We recommend that the Commission ensure that proper investment controls are in place regardless of the contractual arrangement used to manage its investment portfolio. The controls necessary for the Commission to control and monitor its investments and service providers should be specified in future contracts. Contract provisions should specify the proper segregation of duties between the Custodian, the Investment Consultant, and the Investment Managers; the provisions should also require periodic independent investment reporting from each service provider.

Management's Response:

Management concurs with recommendation and the controls are already in place.

Section 2:

The Commission Could Not Obtain Detailed Billing Information Under the "Wrapped" Fee Arrangement for Investment Services, and Prior Approval Was Not Given for All Payments

The Commission could not obtain detailed billing information needed to accurately account for its contracted investment services under the "wrapped" fee arrangement. Additionally, the Investment Consultant/Custodian firm automatically debited the Commission's accounts for the first two of four quarterly payments without receiving the Commissioner's approval for payment. The Commission's procedure for payments of expenditures requires approval of all invoices for expenditures by the Commissioner prior to payment.

In fiscal year 1996, the Commission had a "wrapped" fee contractual arrangement for its contracted investment services. Under this arrangement, the Commission received one quarterly billing from the Investment Consultant/Custodian firm for all contracted investment services (including consulting, custodianship, and investment management). The Investment Consultant/Custodian firm paid a portion of the quarterly fee it received from the Commission to the Commission's three Investment Managers.

The Commission could not obtain from its Investment Consultant/Custodian firm details regarding the portion of the total quarterly fee retained by the firm and the portion the firm paid to each of the three Investment Managers.

Fee details needed from the Investment Consultant/Custodian firm to properly report professional fees in the Commission's financial statements were not received until September 5, 1996. In July 1996, the Commission requested that the State Auditor's Office Project Manager for this audit contact the Investment Consultant/Custodian firm on its behalf to obtain the billing detail necessary to comply with the Comptroller of Public Accounts' Financial Reporting Guidelines. The Project Manager made requests to the Investment Consultant/Custodian firm for this information during the months of July and August 1996. Additionally, confirmations of amounts paid for services were requested and received from the Investment Managers in August 1996.

Recommendation:

The Commission should specify in contract provisions the level of billing detail required for proper accounting and compliance with state reporting requirements.

The Commission should ensure compliance with its established procedures for payment of expenditures.

Management's Response:

Management concurs with recommendation. The Fund is no longer in the "wrap fee" arrangement and proper procedures are being followed.

Section 3:

The Commission Is Operating Without an Effective Income Anticipation Schedule to Accurately Forecast Dividend and Interest Revenue

The Commission is operating without an effective income anticipation schedule to accurately forecast dividend and interest revenue. As a result, a material adjustment in the amount of $181,652 was needed to correct the prior years' reported accrual and revenue associated with investment interest income.

We reported this issue two years ago. The Commission attempted to use an estimated revenue report contained within the Custodian's monthly report to address the prior years' finding. However, the Custodian's estimated income report did not recognize interest income in fiscal year 1995 associated with the Guaranteed Investment Contract (GIC). Additionally, in fiscal years 1993 and 1994, the Custodian's reported accrued income for the GIC was incorrect.

On July 26, 1996, the Commission received a GIC report which contained the end-of-month balances to date, as well as the projected monthly balances to maturity (May 29, 1997). Based on this information, the Contract Accountant recorded a $258,216 accrual for fiscal year 1996 to make the interest accrual and revenue account current.

However, only $76,564 of this amount should have been accrued in fiscal year 1996. The remaining $181,652 should have been accrued in prior years as shown below:

- 1993 $47,876
- 1994 $63,855
- 1995 $69,921

Financial reporting standards require interest and dividend income to be recognized during the year it is earned.

Recommendation:

We recommend that the Commission develop and maintain an income-anticipation schedule so that it can properly forecast and report investment dividend and interest accruals and revenue.

The custodian's estimated income report should be compared to the Commission's income-anticipation schedule to ensure accuracy of the report. The Commission should verify that anticipated dividend and interest revenue is actually received.

Management's Response:

The recommendation for the Commission to develop and maintain an income-anticipation schedule has been discussed at great length with the Contract Accountant. The Accountant will research this issue and bring a recommendation to the Board in FY98.

Section 4:

Efficiency Can Be Achieved by Using the Audited Fiscal Year Financial Statements in the Commission's Annual Report to Local Departments

Efficiency of operations can be achieved by using the audited fiscal year financial statements in the Commission's annual report to local departments. Currently, the Commission produces an unaudited calendar-year financial statement for inclusion in its annual report to local departments. Producing the unaudited calendar-year financial statement results in additional demands on already scarce resources and additional cost for the Contract Accountant's time. There is no assurance as to the accuracy of the unaudited calendar year financial statements.

Using the audited fiscal year financial statements in the Commission's annual report to local departments would ensure the accuracy of the information reported and eliminate the additional staff and accountant time needed to prepare the unaudited calender-year financial statement.

Recommendation:

We recommend that the Commission use the audited fiscal year financial statements in its annual report to local departments.

Management's Response:

The Commission prepares a Calendar Year Report for its membership which is distributed at the June State Firemen's Convention, and mailed to all participating departments. Staff has already decided to include in that Report, the fiscal year financial report, rather than a calendar year financial report. However, in order to meet our June deadline, there will be times that the report will have to carry the "unaudited" version of the AFR since we usually do not have the audited version by mid-May, which is our deadline. The report contains a great deal of information for our membership, other than just the financial report. This report is also used as a "marketing" tool throughout the year for prospective departments, and informational literature for other pension professionals.

Appendix 1:

Objective, Scope, and Methodology

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Appendix 1:

Objective, Scope, and Methodology

Objective

Our objectives were to accomplish the following:

- Perform a financial audit in order to express an opinion on the fiscal year 1996 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 (including regression models) 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.
- Evaluate the status of prior year findings that have a significant impact upon other audit objectives. This includes prior year findings related to improving internal controls over cash receipts and improving accounting and reporting of investment activities and certain financial transactions.
- Follow up on issues identified during the small agency management control follow-up audit in April 1996. The results of this work are reported in *An Audit Report on Management Controls at the Office of the Fire Fighters' Pension Commissioner* (SAO Report No. 98-003).

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 the reporting of selected accounts, including investments with a market value of $19.4 million, revenues of $3.2 million, and expenditures of $1.5 million; other tests of selected account balances included cash, accounts payable, 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

- Performing tests of details on cash, revenues, expenditures, investments, accounts payable, compensable leave, fixed assets, and fund balance

We also tested for compliance with GASB 3 and GASB 5.

Other Information

Fieldwork was conducted from March 1997 through July 1997. 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:

- Robin R. Smith, CPA (Project Manager)
- James T. Stolp, CPA (Team Member)
- Susan A. Riley, CPA (Quality Control)
- Carol A. Smith, CPA (Audit Manager)
- Craig D. Kinton, CPA (Director)

Appendix 2:

Agency Profile

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Appendix 2:

Agency Profile

The Office of the Fire Fighters' Pension Commissioner (Commission) was created to administer the Fire Fighters' Relief and Retirement Fund, a cost-sharing multiple employer pension system. This Fund was created in 1977 by Senate Bill 411, 65th Legislature, along with the applicable benefit provisions. The Fire Fighters' Relief and Retirement 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, Senate Bill 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 1996, the fund had assets with a market value of $19.4 million. There were 144 member departments. The Commission mails over 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 1996, there were 138 departments participating in TLFFRA. Of that number, 37 are fully paid departments, 4 are partially paid, and 97 are volunteer. There are 6,385 participating fire fighters. Total assets have a market value of $622 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 1996, 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 costs and "buybacks" of vested benefits. 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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Auditor’s Report on Internal Controls

July 15, 1997

Board of Trustees
Fire Fighters’ Pension Commissioner

Members of the Board:

We have audited the general purpose financial statements of the Office of the Fire Fighters’ Pension Commissioner (Commission), a component unit of the State of Texas, as of and for the year ended August 31, 1996, and have issued our report thereon dated July 15, 1997.

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, 1996, 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 Detailed Issues and Recommendations section of our management letter.

Board of Trustees
Fire Fighters' Pension Commissioner
July 15, 1997
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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.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of the Commission in a separate State Auditor's Report, *An Audit Report on Management Controls at the Office of the Fire Fighters' Pension Commissioner* (SAO Report No. 98-003). This report describes a material weakness in the control environment during the subsequent year.

This report is intended for the information of the Board of Trustees, 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

Lawrence F. Alwin, CPA
State Auditor

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Appendix 4:

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

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

July 15, 1997

Board of Trustees
Fire Fighters' Pension Commissioner

Members of the Board:

We have audited the general purpose financial statements of the Fire Fighters' Pension Commissioner (Commission), a component unit of the State of Texas, as of and for the year ended August 31, 1996, and have issued our report thereon dated July 15, 1997.

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, the objective of our audit of the general purpose financial statements 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 one instance of noncompliance that is required to be reported herein under *Government Auditing* Standards for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in the Commission's 1996 financial statements.

The Commission is not in compliance with state law which requires maintaining of cash balances in the State Treasury. The detailed finding related to this instance of noncompliance is included in the State Auditor's Report, *An Audit Report on Management Controls at the Office of the Fire Fighters' Pension Commissioner* (SAO Report No. 98-003).

We considered this instance of noncompliance in forming our opinion on whether the Commission's 1996 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated July 15, 1997, on those general-purpose financial statements.

This report is intended for the information of the Board of Trustees, 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

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