

# Internal Audit Department

O R A N G E C O U N T Y  
 6<sup>th</sup> Largest County in the USA

## FINANCIAL AUDIT: AUDIT OF THE SOURCE OF FUNDING FOR THE OCEA PENSION ENHANCEMENTS FOR FISCAL YEARS 2008-09, 2009-10, & 2010-11

OCEA members themselves, and not the County, fully paid **\$101.2 million** for Pension Enhancements for Fiscal Years 2008-2009, 2009-2010, & 2010-2011

We have completed our Audit of the Source of Funding for the 2004 Orange County Employees' Association (OCEA) Pension Enhancements. We found that OCEA members themselves and not the County fully and accurately paid for the cost of the pension enhancements of \$101.2 million (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2008-09, 2009-10, & 2010-11. The \$101.2 million paid included additional employee contributions of \$67.6 million and health insurance cost savings of \$33.6 million.

AUDIT No: 1216  
 REPORT DATE: NOVEMBER 8, 2012

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**Deputy Director:** Eli Littner, CPA, CIA  
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**RISK BASED AUDITING**

GAO & IIA Peer Review Compliant – 2001, 2004, 2007, 2010



American Institute of Certified Public Accountants Award to Dr. Peter Hughes as 2010 Outstanding CPA of the Year for Local Government

GRC (Government, Risk & Compliance) Group 2010 Award to IAD as MVP in Risk Management



2009 Association of Certified Fraud Examiners' Hubbard Award to Dr. Peter Hughes for the Most Outstanding Article of the Year – Ethics Pays



2008 Association of Local Government Auditors' Bronze Website Award



2005 Institute of Internal Auditors' Award to IAD for Recognition of Commitment to Professional Excellence, Quality, and Outreach



ORANGE COUNTY BOARD OF SUPERVISORS'  
**Internal Audit Department**

*GAO & IIA Peer Review Compliant - 2001, 2004, 2007, 2010*

*Providing Facts and Perspectives Countywide*

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**OC Fraud Hotline (714) 834-3608**

# Letter from Dr. Peter Hughes, CPA

## Transmittal Letter



**Audit No. 1216**    **November 8, 2012**

**TO:** Members, Board of Supervisors  
Robert J. Franz, Interim County Executive Officer

**FROM:** Dr. Peter Hughes, CPA, Director  
Internal Audit Department

**SUBJECT:** Financial Audit: Audit of the Source of Funding for  
the OCEA Pension Enhancements for Fiscal  
Years 2008-09, 2009-10, & 2010-11

We have completed our Audit of the Source of Funding for the OCEA Pension Enhancements to determine if the OCEA members fully paid for the cost of the 2.7% at age 55 pension benefit formula enhancements for Fiscal Years 2008-09, 2009-10, & 2010-11. The final report is attached for your review.

Each month I submit an **Audit Status Report** to the BOS where I detail any critical and significant audit findings released in reports during the prior month and the implementation status of audit recommendations as disclosed by our Follow-Up Audits. Accordingly, the results of this audit will be included in a future status report to the BOS.

Please feel free to call me should you wish to discuss any aspect of our audit report. Additionally, we will request your department complete a **Customer Survey** of Audit Services. You will receive the survey shortly after the distribution of our final report.

### ATTACHMENTS

Other recipients of this report are listed on the **OC Internal Auditor's Report** on page 4.

# Table of Contents



*Financial Audit:  
Audit of the Source of Funding for the OCEA  
Pension Enhancements for  
Fiscal Years 2008-09, 2009-10, & 2010-11  
Audit No. 1216*

<b>Transmittal Letter</b>	<b>i</b>
<b>OC Internal Auditor's Report</b>	
<b>OBJECTIVES</b>	<b>1</b>
<b>RESULTS</b>	<b>1</b>
<b>BACKGROUND</b>	<b>2</b>
<b>SCOPE AND METHODOLOGY</b>	<b>3</b>
<b>SCOPE EXCLUSIONS</b>	<b>4</b>

# OC Internal Auditor's Report



**Audit No. 1216**

**November 8, 2012**

TO: Members, Board of Supervisors  
Robert J. Franz, Interim County Executive Officer

FROM: Dr. Peter Hughes, CPA, Director  
Internal Audit Department

SUBJECT: Financial Audit: Audit of the Source of Funding for the OCEA Pension Enhancements for Fiscal Years 2008-09, 2009-10, & 2010-11

## Audit Highlight

The Internal Audit Department determined that the Orange County Employees Association (OCEA) members themselves and **not** the County fully and accurately paid for the cost of the pension enhancements (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2008-09, 2009-10, & 2010-11, totaling \$101.2 million, which included additional employee contributions of \$67.6 million and health insurance cost savings (reduced employee healthcare benefits) of \$33.6 million.

## OBJECTIVES

In accordance with our *FY 2012/2013 Audit Plan and Risk Assessment* approved by the Audit Oversight Committee and Board of Supervisors, we conducted an audit of the source of funding for the 2004 Orange County Employees' Association (OCEA) pension enhancements (the 2.7% @ age 55 benefit formula). The objective of the audit was to determine if OCEA members' additional retirement contributions and related health insurance cost savings under the OCEA contracts of 2004 fully and accurately covered the cost of the pension enhancements for Fiscal Years 2008-09, 2009-10, & 2010-11. Our audit was conducted in accordance with professional standards established by the Institute of Internal Auditors.

## RESULTS

The Internal Audit Department determined that OCEA members themselves and **not** the County fully and accurately paid for the cost of the pension enhancements (2.7% @ age 55 benefit formula) as agreed upon in their 2004 Memorandum of Understanding for Fiscal Years 2008-09, 2009-10, & 2010-11, totaling \$101.2 million, which included additional employee contributions of \$67.6 million and health insurance cost savings (reduced employee healthcare benefits) of \$33.6 million.

The OCEA members paid additional employee retirement contributions of \$21.9 million for FY 2008-09; \$20.8 million for FY 2009-10; and for FY 2010-11 a total of \$24.9 million was paid. In addition, the reduced employee healthcare benefits resulted in health insurance cost savings of \$11.2 million for each fiscal year.

We noted the following:

1. County Executive Office (CEO)/Office of Finance accurately computed the dollar amount due from OCEA's members to fully cover the Pension Enhancements of 2004 for Fiscal Years 2008-09, 2009-10, & 2010-11.



2. CEO/Office of Finance accurately included the health insurance cost savings concessions agreed to by OCEA in 2004 to the amount due from OCEA's members in 2008-09, 2009-10, & 2010-11 for the Pension Enhancements of 2004.
3. CEO/Office of Finance correctly obtained an annual actuarial study of the benefit costs to determine if any adjustments were needed regarding the cost of the Pension Enhancements of 2004.

## BACKGROUND

The County of Orange is a participant of the Orange County Employees Retirement System (OCERS), which provides retirement benefits for employees of the County and certain districts. Retirement benefit costs are based on OCERS' actuarial study. Both the employer and employee (member) are required to make a mandatory contribution each payroll period to OCERS to fund the retirement plan. Based on the study, OCERS recommends to the CEO/Office of Finance the employer contribution rates for the applicable fiscal year. The Orange County Board of Supervisors (BOS) approves and adopts the rates.

### Pension Enhancement

In 2001, the California State Legislature passed Assembly Bill 616 that provided options for new retirement benefit formulas for public sector general members covered by both Public Employees' Retirement System (PERS) and 1937 County Employees Retirement Act. One of the available formulas is known as 2.7 % @ 55. On August 24, 2004, the BOS adopted Resolution No. 2004-247 to implement a **2.7 % @ age 55** retirement formula for General Members of the OCERS retiring on or after July 1, 2005. This is the enhanced retirement plan for the OCERS General Members.

### Source of Funding for Pension Enhancement

Under the 1937 County Employees Retirement Act, the employer and employees can agree that employees will pay a portion of the benefit cost that would customarily be the employer's cost. This arrangement is referred to as "*Reverse Pick Up*". Through negotiations with the labor organizations, e.g. Orange County Employee Association (OCEA), the bargaining units agreed that the pension enhancement would be without any additional cost to the County; therefore, they would make additional employee contributions (Reverse Pick Up) to the system.

Also, they agreed to the health benefit changes (increased co-payments, higher deductibles and increased employee payroll deductions). The combination of Reverse Pick Up and Health Insurance Cost Savings are required to cover the annual cost of implementing the Enhanced Retirement Benefits. In addition, there is an annual review of the enhanced benefits and costs to determine if any adjustments to the future Reverse Pick Up calculations are needed.

# OC Internal Auditor's Report



## Reverse Pick Up

The Reverse Pick Up is calculated based on the cost of the enhanced retirement benefits, net of the health insurance cost savings (offset) to the County:

$$\begin{array}{rclcl} \text{Enhanced} & & \text{Health} & & \text{Reverse} \\ \text{Retirement} & - & \text{Insurance} & = & \text{Pick} \\ \text{Expense} & & \text{Savings} & & \text{Up} \end{array}$$

The reverse pick up rate for each of the bargaining units varies, as it is a result of the calculation and negotiations between labor organizations. The established rates are set forth in the corresponding Memorandum of Understanding (MOU). The CEO/Office of Finance annually reviews the costs and adjusts the reverse pick up rate accordingly.

## Enhanced Retirement Expense

OCERS had The Segal Company, an actuary, perform actuarial studies which resulted in the issuance of Actuarial Valuation and Review reports as of December 31, 2006, December 31, 2007, and December 31, 2008, which established the funding requirements for Fiscal Years 2008-2009, 2009-2010, and 2010-2011, respectively. The County uses the relative-ratio based methodology to determine the additional employee contribution toward the "2.7% at 55" retirement benefit formula. The relative-ratio method takes the ratio of the total employer contribution rate increase from pre-enhancement to the total employer contribution rate in the Actuarial Study Report for calculating the cost of the enhanced retirement for subsequent fiscal years.

## Health Insurance Savings

The labor organizations agreed to the changes of health benefits effective January 1, 2005. The health insurance cost savings is calculated based on health cost pricing for the 2005 proposed health plans (increased co-payments, higher deductible and increased employee payroll deductions). In August 2004, Mercer, Health Benefit Consultant, performed the annual health insurance cost savings projection for the County. Subsequently, CEO/Office of Finance updated the projection based on budgeted health insurance costs and employees' actual plan enrollment for FY 2005-06. It was determined that the health insurance costs savings was \$16 million per fiscal year. This savings was allocated to all bargaining units, which are affected by the health plan change. The allocation was based on the ratio of health insurance cost of each individual bargaining unit applicable to 2.7% @ 55 savings to the total health insurance cost. As a result, **OCEA members were allocated the amount of \$11.2 million per fiscal year (or a total of \$33.6 million for three Fiscal Years).**

## SCOPE AND METHODOLOGY

Our audit was limited to evaluating the calculated additional employee contributions (Reverse Pick Up) and health insurance cost savings offset of selected OCERS General Members, associated with the implementation of the enhanced retirement plan. Our review covered six (6) bargaining units of the Orange County Employees Association (OCEA), eligible for the 2.7% @ age 55 retirement benefits, during Fiscal Years 2008-2009, 2009-2010, and 2010-2011. The bargaining units are: Community Services Unit (CS), County General Unit (GE), County Healthcare Professional Unit (HP), Office Services Unit (CL), Sheriff's Special Officer and Deputy Coroner Unit (SO), and Supervisory Management Unit (SM), totaling to approximately 11,800 employees (or 68% of the County's workforce).



# OC Internal Auditor's Report



Our methodology included inquiry, auditor observation and examination, and testing of relevant documentation. In the course of conducting the audit, we interviewed personnel at various County departments, including CEO and the Auditor-Controller's Office.

## SCOPE EXCLUSIONS

We did not assess the actuarial assumptions and projections made by the actuary as the basis for the calculations of employer/employee pension contributions nor Mercer's health insurance costs savings determination.

We did not review cost allocations for pension enhancements represented by other labor organizations, e.g. Orange County Attorney Association (OCAA); or other benefit formulas, e.g. 3% @ age 50. In addition, we did not review the calculations of prior agreements of employee and employer retirement contributions.

## Acknowledgment

We appreciate the courtesy and cooperation extended to us during the audit by the personnel of the County Executive Office/Office of Finance and the Auditor-Controller's Office. If we can be of further assistance, please contact me directly at (714) 834-5475 or Alan Marcum, Senior Audit Manager at (714) 834-4119.

## Attachments

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

Members, Audit Oversight Committee  
Frank Kim, Interim Chief Financial Officer  
Mitch Tevlin, Manager, County Executive Office/Budget Development  
Jan Grimes, Chief Deputy Auditor-Controller  
Philip Daigneau, Director, Information Technology, Auditor-Controller  
Teresa White, Manager, CAPS+ HR/Payroll System, Auditor-Controller  
Steve Danley, Director, Human Resource Services  
Foreperson, Grand Jury  
Susan Novak, Clerk of the Board of Supervisors