



Office of the City Auditor

**Report to the City Council
City of San José**

**PENSIONABLE EARNINGS:
TIGHTER CONTROLS AND
MORE TRANSPARENCY CAN
ENSURE RETIREMENT
CONTRIBUTIONS
CONTINUE TO BE
ACCURATE**

March 8, 2018

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

Pensionable Earnings: Tighter Controls and More Transparency Can Ensure Retirement Contributions Continue to be Accurate

The City has two primary retirement systems, the Federated City Employee Retirement System and the Police and Fire Department Retirement Plan. The plans are funded through bi-weekly payroll deductions from employee paychecks as well as City contributions. The amount contributed by the City and employees is calculated as a percentage of an employee's earnings. In FY 2016-17, the City's contributions to the two plans totaled more than \$328 million, and employee contributions totaled \$73 million.

"Pensionable earnings" refers to the types of pay that are used to calculate retirement benefits, such as regular pay, sick pay, or vacation pay. Other types of pay, such as overtime or an auto allowance, are not included in the calculation of an employee's retirement benefits, and not included in the bi-weekly contribution calculations. The types of pay that are pensionable are outlined in the Municipal Code or determined through negotiations between the City and its employee bargaining groups.

The objective of this audit was to assess the accuracy of the City's pensionable earnings calculations.

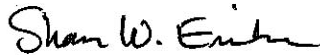
Finding 1: The City Appears to Calculate Retirement Contributions Correctly; However, It Should Tighten Controls to Ensure Continued Accuracy. Based on earnings data for June and July of 2017, it appears that the City has been calculating employee pension contributions correctly. However, problems have occurred in the past, and the City should take steps to ensure the system continues to work properly in the future.

Currently, the Municipal Code and agreements with the City's employee bargaining units do not clearly define the pensionable status of all types of earnings, including premium pay paid pursuant to the Fair Labor Standards Act (FLSA). To ensure pay codes are utilized correctly, our 2009 *Audit of Pensionable Earnings* recommended staff maintain authoritative documentation for all earnings codes; unfortunately, this has not been implemented to date. In addition, we recommend that the City should clarify in the Municipal Code the term FLSA premium pay.

To improve transparency, the City should post the list of earnings codes and their pensionable status online as is done in some other jurisdictions. This would allow employees and bargaining units to better understand how their retirement contributions and benefits are being calculated. Finally, to ensure payroll system changes are implemented as intended and to guard against incorrect changes, the City should tighten controls around the pay code change process.

This report contains four recommendations. We will present this report at the March 15, 2018 meeting of the Public Safety, Finance, and Strategic Support Committee. We would like to thank the Finance Department, the Office of Employee Relations, the Information Technology Department, the Human Resources Department, the Office of Retirement Services, and the City Attorney's Office for their time and insight during the audit process. The Administration has reviewed this report and their response is shown on the yellow pages.

Respectfully submitted,



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This report is also available online at www.sanjoseca.gov/audits

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Introduction

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability, and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, and effectiveness of City operations and services.

In accordance with the City Auditor's Fiscal Year (FY) 2017-18 Work Plan, we have completed an audit of the accuracy of the City's pensionable earnings calculations.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this report.

The Office of the City Auditor thanks the City's Finance Department, the Office of Employee Relations, the Human Resources Department, the Information Technology Department, the Office of Retirement Services, and the City Attorney's Office for their time and insight during the audit.

Background

Retirement plans can generally be grouped into two categories:

- *Defined benefit plans* - often referred to as a "pension" plan, defined benefit plans specify regular benefits to be paid to a retiree over the course of their lifetime. Those benefits are based on a formula, which accounts for factors like length of service and the employee's salary. The amount of money added to the plan each year is based on an estimate of how much will be needed to cover future pension payments and can vary from year to year.
- *Defined contribution plans* – these plans specify how much money is put into the retirement plan, but do not specify the benefit amount paid to the employee upon retirement. The amount available for future retirement benefits is simply the sum of the amount contributed over time, as well as any investment income earned over time. These benefits can be paid out in a lump sum or until the funds are exhausted.

The City's primary retirement plans for its full-time employees are defined benefit plans: The Police and Fire Department Retirement Plan, and the Federated City Employees' Retirement System.¹ Although there are only two plans, there are multiple tiers within each plan, as described below.

- The *Police and Fire Department Retirement Plan* (Police and Fire Plan) covers sworn employees of those departments, and is governed by a Board of Administration under San José Municipal Code Section 3.36. The Police and Fire Plan is comprised of two tiers, Tier 1 and Tier 2. With few exceptions, Tier 1 is closed to new employees, but does still contain active employees.
- All other eligible City employees are covered through the *Federated City Employees' Retirement System* (Federated), governed by its own Board of Administration through Municipal Code Section 3.28. Federated has multiple tiers. With few exceptions, Tier 1 is not open to new employees; however, it still contains active employees. Tier 2 is the default retirement option provided to new employees and is further broken into sub-tiers (e.g., Tier 2A and Tier 2B). Employee eligibility in these sub-tiers is primarily based on when an employee began service with the City or whether they had previously worked in the City or a California Public Employees' Retirement System (CalPERS) member agency.²

As of June 30, 2017, there were 4,954 active employees in the plans.³ There were an additional 6,307 retirees and beneficiaries receiving benefits. The Office of Retirement Services administers benefits for both plans. See Appendix B for more details on the Police and Fire and Federated plans.

Funding the City's Retirement Plans

The respective retirement system's Boards of Administration use independent actuaries to determine how much the City and its employees should contribute into the system to ensure sufficient funds are available to pay retirement benefits. This amount is divided by expected payroll to determine a "contribution rate." There is a contribution rate for both the City's contribution as well as the

¹ The City also has a defined contribution plan for certain full-time executive management employees (the Tier 3 plan). The City created the Tier 3 defined contribution plan in 2013. The plan is in accordance with Internal Revenue Code Section 401a, and is similar to a traditional 401k. Currently, both the employee and City contribute 3.75% of an employee's compensation to the plan. The City's Department of Human Resources administers the plan, which is governed by San José Municipal Code Section 3.49. As of June 30, 2017, there were 45 active employees who were Tier 3 plan members. The City also offers a voluntary deferred compensation plan under section 457 of the Internal Revenue Code; there were 3,500 active participants as of June 30, 2017.

² The California Public Employees' Retirement System (CalPERS) is a defined benefit plan through the State of California, and is the nation's largest public pension fund. See <https://www.calpers.ca.gov/page/home> for more information on CalPERS.

³ There were 1,544 active employees in the Police and Fire Department Retirement Plan and 3,410 active employees in the Federated City Employees' Retirement System.

employee portion. The different tiers within the retirement system have different contribution rates. See Appendix B for more detail.

Contribution rates are entered into PeopleSoft, the City's human resource management system, to calculate actual employee and City contributions. Contributions occur on a biweekly basis during the normal payroll process. The contribution rate is applied against an employee's earnings to determine the amount to be withheld from his or her paycheck and the amount to be contributed by the City.⁴ As discussed later, not all earnings are included in the calculation to determine retirement contributions.

The City's total contributions to the two plans totaled more than \$328 million in FY 2016-17. Employees contributed an additional \$73 million.

Time-Reporting and Payroll Processes

City employees are responsible for completing their time cards bi-weekly for payroll processing. City employees choose from different time reporting codes to report their time (e.g., regular pay, sick leave, etc.) Each time reporting code is assigned a "pay code" (or "earnings code") in PeopleSoft. Some of these codes are available to all employees (e.g., Regular Pay, Sick Leave, Vacation, Jury Duty). In other cases, employees are limited to time reporting codes associated with their employee work group. For example, Motorcycle Duty Pay is only available to sworn Police Officers.

Other types of earnings codes, such as Bilingual Pay, are not time dependent and do not have time reporting codes associated with them.⁵ These codes are entered by Payroll staff directly into PeopleSoft once appropriate approvals and documentation have been received.

At the end of FY 2016-17, there were about 325 earnings codes used to account for employee activity.

At the end of every pay period, department timekeepers and supervisors review and approve employee time cards. Timekeepers review for completeness and supervisors for accuracy. Finance Department's Payroll group and the Human Resources Department are responsible for implementing most special pays that are not shown on the timecard (e.g., Health in Lieu, Bilingual Pay).

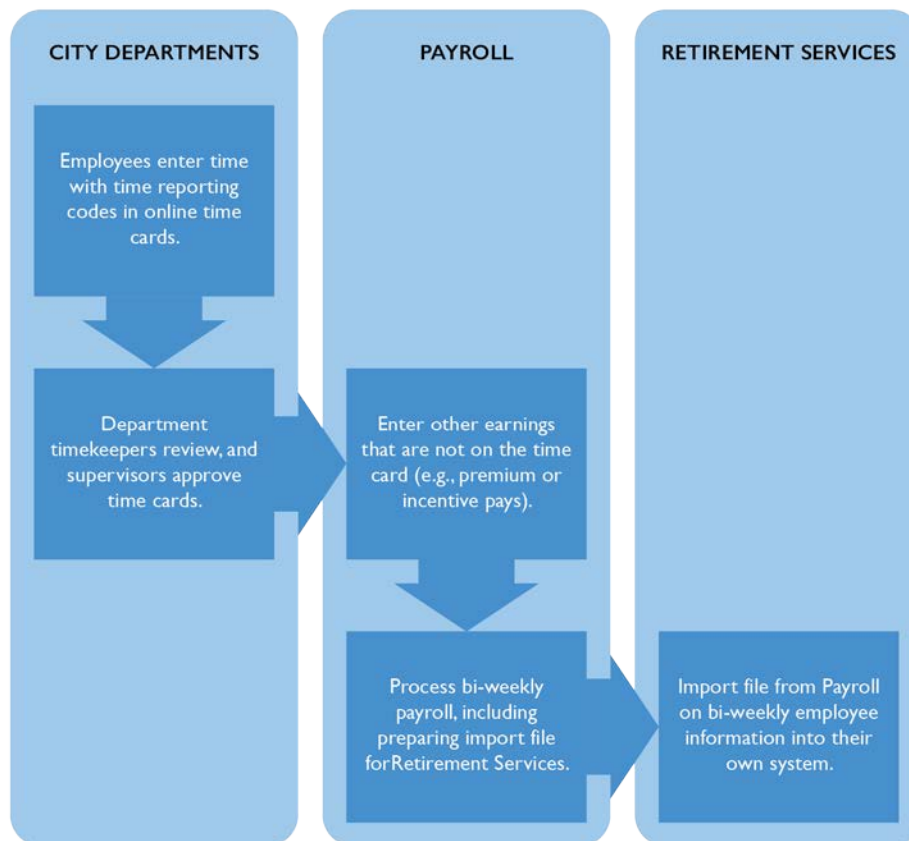
When Finance has completed processing payroll for the pay period, the payroll system creates a file containing employee compensation and contribution data for

⁴ In actual practice, the City prefunts, or pays its contribution, for the Tier I plans at the beginning of the fiscal year. During the biweekly payroll process, the City's contribution is calculated and accounted for in the City's financial management system to properly track the City's contribution within the City's various departments and funds.

⁵ For example, eligible employees can earn Full-Time Bilingual Pay if their department has requested bilingual pay based on the employee's use of a non-English language as part of their regular job duties.

the Office of Retirement Services. The information in those files is critical for maintaining and administering pension benefits. Retirement Services uploads the information into its PensionGold system to track and administer benefits.

Exhibit I: Bi-Weekly Time-Reporting and Payroll Process



Source: Audit staff summary of process described by City staff from the Finance Department's Payroll group, Information Technology Department, Human Resources Information Systems group, and the Office of Retirement Services' Information Technology group.

Pensionable Earnings

The types of pay that are used to calculate retirement benefits and contributions are referred to as “pensionable earnings”. Not all employee earnings are “pensionable”. Also, the different retirement plans use different pay codes to calculate retirement contributions.

To calculate retirement contributions, PeopleSoft applies the contribution rate, which has been pre-programmed into the City's payroll system, to those pay codes deemed “pensionable earnings”. For example, a Tier I sworn Police employee might receive pay for five different earnings codes on one paycheck: PPA (POST Pay Advanced), PRT (4 percent Police Retention Pay), REG (Regular), SIC (Sick Leave), and UAB (Uniform Allowance Bi-Weekly). However, only three of those

pays (PPA, REG, and SIC) would count in the calculation of this employee's retirement contribution.

Pensionable Pay Administration

Determining whether retirement contributions are calculated and accounted for correctly is a shared responsibility among multiple City offices and departments. The roles of departments vary during each stage of the pensionable pay process. Some departments are involved in the initial set-up of pensionable earnings while others are involved in administering pensionable earnings in general.

Office of Employee Relations (OER) – Under direction of the City Council and subject to limitations in State law and the City Charter, OER is responsible for negotiating on behalf of the City with employee bargaining units regarding the terms and conditions of work. The pays that count toward employee pensions are a result of such negotiations and the terms are most often memorialized either in the Municipal Code, in a side agreement, or drafted in the memoranda of agreement between the City and a bargaining unit. OER also interprets labor contracts so that the City implements those negotiated terms as intended.

Human Resources Information Systems Team within Human Resources (HRIS) – HRIS sets up new employees in PeopleSoft, assigning them to an employee group and retirement tier within either the Federated or Police and Fire plans. These selections auto-populate the appropriate time reporting codes available to the employee for when they enter their time cards.

Payroll Group within Finance – Payroll manages the bi-weekly payroll process that ensures employees receive pay, and that retirement contributions are accurately calculated for both the City and employees. Payroll also transmits employee earnings and contributions data each pay period to Retirement Services through an interface file that lists the individual employee's pensionable earnings, hours worked, and other information.

Information Technology (IT) – IT is the custodian of PeopleSoft. IT is responsible for providing the technical infrastructure for pensionable earnings by setting up interfaces and testing changes to the system as necessary. IT also ensures security over PeopleSoft data by limiting access to appropriate staff across the City.

Office of Retirement Services – Retirement Services administers the City's two defined benefit plans, as well as retiree health care. Retirement Services receives bi-weekly payroll data from Payroll through the aforementioned electronic interface file. This is uploaded into its PensionGold system to update employee retirement accounts.

Prior Audits

In December 2009, the City Auditor's Office published *Audit of Pensionable Earnings and Time Reporting*.⁶ That report reviewed the City's calculation of pensionable earnings and noted errors that impacted the City's payroll and retirement systems. These errors resulted in incorrect pensions to some retirees. At the time of this audit, the City was still working to correct past errors, which could result in changes to retiree pensions. Retirement Services and other City departments are currently resolving these errors. As of June 30, 2017, seven of fifteen recommendations from that report were still open.

In February 2013, the City Auditor's Office published *Deferred Compensation: The City Can Streamline and Improve the Administration of Its Deferred Compensation Program*.⁷ That audit found that the file that transmits payroll information to the third-party administrator had misallocated amounts for 20 employees. The error was the result of 10 duplicate names (equating to 20 individuals), and the system using names to transmit the data rather than a unique identifier. The Human Resources and Information Technology departments worked together to fix the transfer file, and made corrections to individuals' accounts.

In November 2017, the City Auditor's Office published *San José's Tier 3 Defined Contribution Plan: The City Should Clarify How Contributions Are Calculated*.⁸ The report found that City had not been calculating contributions in accordance with the definition of compensation for the plan in the Municipal Code. The City Attorney's Office is working with outside tax counsel to clarify the term compensation in the Municipal Code.

Audit Objective, Scope, and Methodology

The objective of our audit was to assess the accuracy of the City's pensionable earnings calculations. We performed the following to achieve our audit objective:

- Reviewed the City Charter and the San José Municipal Code sections governing the Federated City Employees Retirement System (Section 3.28) as well as the Police and Fire Department Retirement Plan (Section 3.36).

⁶ For Report 09-10 *Audit of Pensionable Earnings and Time Reporting: Errors Resulted in Higher Pensions; Time Reporting Codes Are Unclear and Duplicative; and Some Pensioners Benefit from the City's Definition of Earnable Income and Highest Salary*, see <http://www.sanjoseca.gov/DocumentCenter/View/3229>

⁷ For Report 13-02 *Deferred Compensation: The City Can Streamline and Improve the Administration of Its Deferred Compensation Program*, see <http://www.sanjoseca.gov/DocumentCenter/View/12173>. Although not related to pensionable earnings for the City's defined benefit plans, the processes for withholding contributions and transmitting such information to the plan administrator is similar.

⁸ For Report 17-09 *San José's Tier 3 Defined Contribution Plan: The City Should Clarify How Contributions Are Calculated*, see <http://www.sanjoseca.gov/DocumentCenter/View/73329>

- Reviewed United States Code Title 26 regarding the definition and regulations of various governmental retirement plans.
- Reviewed memoranda of agreement and applicable side agreement for the City's bargaining units; benefit fact sheets for all the City's retirement tiers including Tier 1, Tier 1A, Tier 1B, Tier 1C, Tier 2, Tier 2B, and Tier 3; and contribution rates posted by the City's Office of Employee Relations.
- Analyzed employee earnings reports for the five biweekly payrolls processed in June and July of 2017 to assess the accuracy of the pensionable earnings calculations. The analysis included earnings of all City employees in all retirement plan tiers of the Federated City Employees' Retirement System (Tier 1, Tier 1B, Tier 1C, Tier 2A, and Tier 2B); and of the Police and Fire Department Retirement Plan (Police Tier 1 and Tier 2; Fire Tier 1 and Tier 2). We worked with the City's Finance Department and the Office of Employee Relations to assess whether the charged earnings codes were correctly being applied for retirement purposes.
- Interviewed staff from the Human Resources Information Systems team, Information Technology, the Payroll group in Finance, and Office of Employee Relations to understand the processes of adding new pensionable pay codes to the City's human resource management system and of assigning new employees to a specific retirement tier that in turn loads available pensionable pays for time charging purposes.
- Interviewed staff from Payroll and Office of Retirement Services about the payroll and contribution data transfer.
- Reviewed sample documents utilized in the pensionable earnings processes, including implementation memoranda and other documents related to changes to PeopleSoft earnings codes, transmittals from Payroll to the Office of Retirement Services, internal retroactive adjustment worksheets, and others.
- Benchmarked the counties of Los Angeles, Alameda, and Contra Costa to identify whether pensionable pay is transparently made available on their websites.

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Finding I The City Appears to Calculate Retirement Contributions Correctly; However, It Should Tighten Controls to Ensure Continued Accuracy

Summary

Based on a review of earnings data for all retirement tiers for June and July of 2017, it appears that the City has been calculating employee pension contributions correctly. However, problems have occurred in the past, and the City should take steps to ensure the system continues to work properly in the future.

Currently, the Municipal Code and agreements with the City's employee bargaining units do not clearly define the pensionable status of all types of earnings, including premium pay paid pursuant to the Fair Labor Standards Act (FLSA). Documenting the authority behind the pensionable status of different earnings can ensure they are utilized correctly. This was recommended in our 2009 *Audit of Pensionable Earnings*; unfortunately, this has not been implemented to date. In addition, we recommend that the City should clarify in the Municipal Code the term FLSA premium pay.

To improve transparency, the City should post the list of earnings codes and their pensionable status online for employees and bargaining units to better understand how retirement benefits are calculated. Finally, to ensure payroll system changes are implemented as intended and to guard against incorrect changes, the City should tighten controls around the pay code change process.

The City Appears to be Calculating Retirement Contributions Correctly

Based on our review of earnings reports for June and July of 2017, it appears that the City was accurately calculating employee pension contributions. To complete this audit, we reviewed earnings data for all Federated and Police and Fire employees in all retirement tiers for the five bi-weekly payrolls processed during those months.⁹ The audit team identified which pay codes were charged by or for employees, and then determined which were being used to calculate retirement contributions. The analysis showed that of the City's 325 different earnings codes, 103 were charged during the two months. Thirty-seven of the codes were being used for calculating retirement contributions. We worked with OER to confirm

⁹ The earnings data was found in separate reports by pay period and included all employee earnings for the given period by employee ID; retirement tier; the earnings and deductions by pay code; and employee and City contributions to the retirement systems.

that those pay codes being used to calculate retirement contributions were being used as intended.

Despite Accuracy of Current Process, Errors Can Occur

Problems have occurred in the past, and the City can take steps to ensure the system continues to work properly in the future. For example, in March 2017, the City codified changes for Tier 2 Police and Fire members resulting from the implementation of the Alternative Pension Reform Framework and the voter-approved Measure F. These changes were for pay periods beginning in FY 2017-18. Unfortunately, the City did not make changes to the payroll system to reflect those changes until the beginning of October, 2017. As a result, pensionable earnings for pay periods between July and September 2017 had to be recalculated and applied retroactively.¹⁰

The resulting confusion and potential need for retroactive adjustments can have significant consequences for the City and its employees as has been shown since our 2009 *Audit of Pensionable Earnings*. A similar issue arose in our 2017 *Audit of the Tier 3 Defined Contribution Plan* where the types of earnings used to calculate Tier 3 contributions did not agree with the Municipal Code definition of compensation for the plan. The City is currently working with outside tax counsel to clarify the term “compensation” in the Municipal Code, as well as to determine whether retroactive changes are necessary.¹¹

The City Should Document Authority for Pensionable Status of Earnings Codes

Documenting the authority behind which earnings codes are to be used in calculating retirement benefits and contributions can help ensure they are being utilized as intended.

The Municipal Code and Labor Agreements Do Not Clearly Define Pensionable Status of All Earnings Codes

Ensuring that there is authoritative support behind the pensionable status of earnings codes will ensure they are used correctly. In some cases, the City’s Municipal Code clearly defines what earnings are or are not pensionable. For

¹⁰ During the course of this audit, OER realized that they had not alerted Payroll of the changes. OER immediately notified Payroll (and the other relevant departments). Payroll, with assistance from IT, then made the necessary changes in PeopleSoft, and made retroactive adjustments to account for the additional pensionable earnings and City contributions. OER also reached out to affected employees to inform them that additional payroll withholdings were necessary to account for the employee portion of prior contributions. Payroll determined 137 employees were affected. Additional employee contributions totaling \$55,000 and City contributions of \$74,000 were required. Payroll began withholding extra contributions from employee paychecks to make up for the amounts under-contributed during the July through September pay periods. These extra withholdings ranged from \$66 to \$740 to be spread over five pay periods (i.e., \$13 to \$148 per pay period).

¹¹ This could result in retroactive contributions for 65 employees totaling about \$14,000 in employee contributions and an equal match in City contributions.

example, holiday pay is deemed part of an employee's pensionable earnings, whereas overtime is not.

In other cases, the types of pays that are included in pensionable earnings depend upon the bargaining unit to which that an employee belongs. The pensionable status of these earnings is determined through negotiations between the bargaining unit and the City.

Unfortunately, not all types of earnings are explicitly referenced in either the Municipal Code or in the agreements with the City's bargaining units. In addition, Payroll and OER do not have a complete listing of codes which show the authority behind the pensionable status of different codes.

In the 2009 *Audit of Pensionable Earnings and Time Reporting*, this same issue was raised and we recommended that the Payroll group in Finance and OER:

Recommendation #7: Obtain authoritative documentation for time reporting codes and earning codes, and create written policies and procedures for proper application of all codes, and for regularly reviewing and maintaining an authoritative time/earning code mapping table.

In the response to the audit, the Administration agreed with this recommendation, writing:

A team consisting of staff from Human Resources, the Office of Employee Relations and Finance will continue to meet regularly. This will include the development of written policies and procedures for the use of time reporting codes and earnings codes and define a schedule for the periodic review of the Time Earning codes. The procedures will also identify roles and responsibilities required for an on-going review process.

However, to date, this recommendation has not been implemented.

Implementation is a shared responsibility between Payroll and OER. Payroll, as the technical experts of PeopleSoft, can develop the list of earnings codes. OER is best able to interpret the agreements with the City's bargaining units and can provide the authoritative references to support the pensionable status of different types of earnings.

The Municipal Code Does Not Clearly Define FLSA Premium Pay

Some premium pays are considered pensionable earnings and others are not. For example, anti-terrorism training pay is pensionable for Police and Fire Plan members who are employed in the Fire Department. Alternatively, paramedic pay is not pensionable.

Municipal Code Section 3.36.020.3 defines compensation for computing retirement benefits for members of the Police and Fire Plan. The Municipal Code specifies premium pay paid pursuant to the Fair Labor Standards Act (FLSA) is pensionable; however, it does not clearly define the term FLSA premium pay. In practice, this term appears to refer to the earnings code “FLSA – Fire Pensionable” that is available for Fire employees to account for regularly scheduled overtime under the FLSA rules.

To ensure there is a common understanding of what premium pays are pensionable, OER and the City Attorney’s Office should clarify the term FLSA premium pay for purposes of Municipal Code Section 3.36.020.3 C.

Recommendation #1: The Office of Employee Relations and the City Attorney’s Office should clarify the term FLSA premium pay in Municipal Code Section 3.36.020.3 C.

The City Should Transparently Document the Sources of Pensionable Earnings

The way the City calculates pensionable earnings is not transparent. Employee and City retirement contributions are included in an employee’s pay stub; however as shown below, it can be difficult to piece together what constitutes pensionable earnings because of the number of different earnings codes.

Employees Cannot Easily Identify Pensionable Earnings

Exhibit 5 depicts a sample employee paycheck showing various types of earnings, including Bilingual Pay, Education & Training Pay, and others. The paycheck also shows how much the employee and the City contributed for retirement in this period. Of the eight different types of earnings shown, four are pensionable earnings and are the basis for calculating retirement contributions. However, these items are not identified as such.

As is shown in the exhibit, it can be difficult for employees to understand how their retirement contributions are calculated, or whether they can check to determine whether contributions are accurate.

1. *Journal of Management Studies*, 1990, 27, 1, 1-14.

Source: PeopleSoft

Recommendation #2: To improve transparency in how retirement benefits and contributions are calculated, the Administration should post a list of pay codes, along with their pensionable status, on its website that:

- a) Differentiates between retirement systems and tiers;
- b) Includes an authoritative source of how the pay code became pensionable, such as the Municipal Code or a Memorandum of Agreement; and
- c) The date the payroll system generated the report.

Ensuring Changes to the Payroll System Are Accurate Is a Shared Responsibility Across Departments

Several City departments, including Finance, OER, IT, and HR, share the collective responsibility to ensure changes to the City's payroll system are accurate.¹² See Appendix A for a summary of the roles and responsibilities of the participating departments in making a payroll change.

Multiple Departments Are Involved in the Process of Modifying the Payroll System to Calculate Pension Contributions

As described previously, negotiations between OER and bargaining units determine which pays are pensionable for which employee groups. After negotiations, OER issues an "implementation memo" to broadly outline any changes to retirement benefit and contribution calculations, if required by the agreement.

Implementation of changes in PeopleSoft involves varying levels of coordination between different departments. For example, staff from Finance's Payroll group, IT, HRIS, Retirement Services, and OER will outline the changes required at regularly scheduled monthly meetings. Bi-weekly meetings with this same group (with the exception of OER) gives staff an opportunity to coordinate the technical work and discuss any issues with the implementation.

City staff report that implementing most pension contribution changes tend to be easy fixes. These simple changes often require little more than Payroll going into PeopleSoft and modifying the affected pay code(s). Payroll documents the change with an internal "Request for PeopleSoft System Change" form¹³; however, the

¹² The Office of Retirement Services is involved in this work, but does not have a responsibility over the accuracy of the City's payroll system.

¹³ For all pay code changes, including the simple ones, Payroll prepares a "Request for PeopleSoft System Change" form that is distributed within the Finance Payroll group. This form indicates: requested by (usually the Office of Employee Relations); approved by (likely someone from the Office of Employee Relations); description of the modifications

implementation of such changes are not reviewed again outside of Finance's Payroll group prior to implementing the changes system wide.

Complicated Changes to the Payroll System Require Much Coordination Between Departments

Some pension contribution changes are more complicated, however, and require more work to ensure the change is implemented as intended. In these cases, the different departments may have additional responsibilities, and a more comprehensive process is used. For example, the audit team reviewed a change where the following work was documented:

- An implementation memo of pay changes was issued by OER to the City Manager's Office, and the departments of Finance, Information Technology, and Human Resources;
- Finance's Payroll group set up new earnings codes and modified existing codes, entered the appropriate calculations for those pay codes, and assigned those codes to the desired accumulator codes¹⁴, as necessary;
- IT tested the new values and calculations;
- OER communicated changes to the affected employees; and
- Finance's Payroll group collected documentation of the above actions, and sent that to OER for review to ensure that the pay code changes were implemented as intended.

The City Should Formalize the Change Process to Ensure Changes Occur as Intended

This comprehensive and documented process appears to meet the U.S. Government Accountability Office (GAO) defined standard for internal controls. Those GAO standards recommend an internal control system that includes segregation of duties and levels of review for key operational processes. These internal controls are meant to reduce the risk of mistakes in implementing pension contribution calculations—such as miscalculating pension contributions, and the risk of disrupting the payroll process in the case of employee turnover within the Payroll group—which can add up over time for the City.

While this more comprehensive process may appear excessive for the simpler pay code changes, those simpler pay code changes do still expose the City to risk. As

requested; prepared by (Payroll Senior Accountant); approved by (Payroll Supervisor); updated by (Payroll Accountant); verified by (Payroll Accountant); as well as a copy of the original memo from the Office of Employee Relations.

¹⁴ Accumulator codes in PeopleSoft are codes that aggregate a series of individual codes for specific purposes. For example, there is a PAY accumulator code that aggregates various common pays, such as regular pay, sick leave, holiday, and others.

such, by applying the City's more comprehensive process to all pay code changes, the City can further reduce its risk of such errors.

This can simply include distributing the Payroll group's "Request for PeopleSoft System Change" form to appropriate staff in OER, IT, and HRIS. This will ensure all parties are aware of the changes and can ensure that they are being implemented as intended.

Recommendation #3: To ensure changes to PeopleSoft are implemented as intended, Finance's Payroll group should distribute copies of the "Request for PeopleSoft System Change" form to appropriate staff in the Office of Employee Relations, the City Attorney's Office, the Human Resource Information Systems team, and Information Technology Department prior to implementation.

Exception Reporting

The above recommendation lowers the City's risk of implementing intended pay code changes incorrectly. However, there is also a risk that unintentional pay code changes could occur. To guard against such unintentional changes, a regular review of pay code changes can help identify which codes reviewers should pay particular attention. Per Payroll staff, PeopleSoft can generate a regular exception report to identify any changes to pay codes that have occurred over a given period. Such a report should be generated by PeopleSoft, and reviewed by the OER and Finance's Payroll staff.

Recommendation #4: To guard against incorrect pay code changes, Finance's Payroll group should run a regular exception report from PeopleSoft to identify any changes in pay codes during the period, and this report should be reviewed by Payroll and the Office of Employee Relations.

Conclusion

In FY 2016-17, the City and its employees made about \$400 million in retirement contributions. While the City appears to be calculating these retirement contributions correctly, errors can still occur. Completing recommendation #7 from the 2009 pensionable earnings audit (obtaining authoritative documentation for earnings codes), would alleviate some of the risk of these occurring. In addition, we recommend the City clarify in the Municipal Code the term FLSA premium pay. The City can also improve transparency around what earnings codes are pensionable. Finally, because ensuring the accuracy of retirement contribution calculations is a shared responsibility, that crosses multiple City departments, the City should formalize some of its processes to ensure earnings code changes occur as intended.

RECOMMENDATIONS

Finding 1: The City Appears to Calculate Retirement Contributions Correctly; However, It Should Tighten Controls to Ensure Continued Accuracy

Recommendation #1: The Office of Employee Relations and the City Attorney's Office should clarify the term FLSA premium pay in Municipal Code Section 3.36.020.3 C.

Recommendation #2: To improve transparency in how retirement benefits and contributions are calculated, the Administration should post a list of pay codes, along with their pensionable status, on its website that:

- a) Differentiates between retirement systems and tiers;
- b) Includes an authoritative source of how the pay code became pensionable, such as the Municipal Code or a Memorandum of Agreement; and
- c) The date the payroll system generated the report.

Recommendation #3: To ensure changes to PeopleSoft are implemented as intended, Finance's Payroll group should distribute copies of the "Request for PeopleSoft System Change" to appropriate staff in the Office of Employee Relations, the City Attorney's Office, the Human Resource Information System team, and Information Technology Department prior to implementation.

Recommendation #4: To guard against incorrect pay code changes, Finance's Payroll group should run a regular exception report from PeopleSoft to identify any changes in pay codes during the period, and this report should be reviewed by Payroll and the Office of Employee Relations.

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APPENDIX A

Payroll Process Roles and Responsibilities

| | Negotiations | Coordination | Pay Codes | Contributions | Benefits | IT Security |
|--|---|---|--|--|----------------------|---|
| OFFICE OF EMPLOYEE RELATIONS (OER) | Negotiate memoranda of agreement (MOA) subject to City Council, City Charter, and applicable laws | Standing monthly (big picture) meetings | Authority on what is pensionable | | | |
| FINANCE'S PAYROLL | | Standing monthly (big picture) meetings Standing bi-weekly (detailed) meetings | Assign pay codes to work groups Assign pay codes to accumulator codes Set premium pays into payroll system | Determine pre-funding levels for contributions Calculate contributions Bi-weekly payroll processing | | |
| INFORMATION TECHNOLOGY | | Standing monthly (big picture) meetings Standing bi-weekly (detailed) meetings | Test payroll system changes | Payroll system set up for payroll data transmit to Retirement Services | | Regulate system (PeopleSoft) access Technical support for payroll system |
| HUMAN RESOURCES INFORMATION SYSTEMS (HRIS) | | Standing monthly (big picture) meetings Standing bi-weekly (detailed) meetings | Assign allowable work group codes | | | |
| OFFICE OF RETIREMENT SERVICES | | Standing monthly (big picture) meetings Standing bi-weekly (detailed) meetings | | Review data transmittal file for errors and upload into Retirement system Work with Payroll on contribution adjustments Track and invest contributions | Issue benefit checks | |

Source: Audit team summary of based on staff interviews.

Note: The City Attorney's Office is consulted, as necessary, for compliance with federal and state laws.

APPENDIX B

Summary of Pension Benefits

Exhibit B.1: Features of the Federated Retirement System Tiers for FY 2017-18

| | Federated | | | | |
|----------------------------|---|---------|---------|---|---------|
| | Tier I | Tier 1B | Tier 1C | Tier 2A | Tier 2B |
| Plan Type | Defined Benefit Plans | | | | |
| Employer Contribution Rate | 103.45% | 106.70% | 106.90% | 17.13% | 20.38% |
| Employee Contribution Rate | 15.36% | 6.60% | 6.99% | 16.48% | 7.72% |
| Benefit Calculation | 2.5% x Years of Service x Final Compensation (75% max.) | | | 2.0% x Years of Service x Final Compensation (70% max.) | |
| Retirement Age | 55 | | | 62 | |
| Vesting | 5 Years | | | | |

Source: The City of San José's Office of Employee Relations' fact sheets and contribution rates.

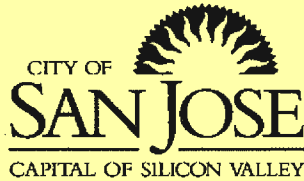
Exhibit B.2: Features of the Police and Fire Retirement Plan Tiers for FY 2017-18

| | Police | | Fire | |
|-----------------------------------|--|----------------------------------|---|----------------------------------|
| | Tier 1 | Tier 2 | Tier 1 | Tier 2 |
| Plan Type | Defined Benefit Plans | | | |
| Employer Contribution Rate | 105.62% | 25.48% | 106.68% | 26.88% |
| Employee Contribution Rate | 20.39% | 15.17% | 21.12% | 16.26% |
| Benefit Calculation | With 20 Years of Service: 50% of Final Comp. | Avg. 3% x Final Comp. (80% max.) | With 20 Years of Service – 50% of Final Comp. | Avg. 3% x Final Comp. (80% max.) |
| Retirement Age | 50 or 55 | 57 | 50 or 55 | 57 |
| Vesting | 10 | 5 | 10 | 5 |

Source: The City of San José's Office of Employee Relations' fact sheets and contribution rates.

Notes:

1. The City prefunds its contributions to Tier 1 plans, but not Tier 2 plans. The numbers above do not reflect adjustments for prefunding.
2. Rates above are the Retirement Board adopted rates based on the June 30, 2016, actuarial valuations and subsequent to the latest actuarial study in order to incorporate provisions of the Alternative Pension Reform Framework and Measure F.
3. Contribution rates include contributions for retiree medical and dental benefits for eligible tiers. Employees hired, rehired, or reinstated after September 27, 2013, who have not met the City's eligibility previously for retiree healthcare, are NOT eligible for retiree healthcare benefits.
4. Retirement age may vary depending on employee years of service.



Memorandum

TO: SHARON ERICKSON
CITY AUDITOR

FROM: Julia H. Cooper
Jennifer Schembri

SUBJECT: SEE BELOW

DATE: March 7, 2018

Approved

Date 3-8-18

SUBJECT: RESPONSE TO AUDIT REPORT – AUDIT OF PENSIONABLE EARNINGS

The Administration has reviewed the Audit of *Pensionable Earnings: Tighter Controls and More Transparency Can Ensure Retirement Contributions Continue to be Accurate* and agrees with the recommendations identified in the report. The following are the Administration's responses to each recommendation.

Consistent with other priority-setting processes, the City Council adopted a new framework for the Administration's response to Audit recommendations in May of 2015. As with other priority processes, the green, yellow, and red light system is utilized to convey the Administration's operational readiness to undertake workload demands. Green administrative responses represent items that are either in existing work plans or are part of work already underway. Yellow administrative responses represent items that would take more than 40 hours including research and policy/ordinance development. Red administrative responses indicate that the item is not feasible. The Administration's response to each of the Audit's recommendations is presented below employing the green, yellow, and red light system consistent with City Council direction in May 2015.

BACKGROUND

The City of San Jose administers two pensions plans for City employees: the Police and Fire Department Retirement Plan for sworn employees, and the Federated City Employees' Retirement System for all other eligible City employees. The plans are funded through bi-weekly payroll deductions from employee paychecks as well as City contributions. The amount contributed by the City and employees is calculated as a percentage of an employee's earnings.

In accordance with the City Auditor's Fiscal Year 2017-18 Work Plan, the City Auditor completed the audit of the accuracy of the City's pensionable earnings calculations.

RECOMMENDATIONS AND ADMINISTRATION'S RESPONSE

Finding 1: The City Appears to Calculate Retirement Contributions Correctly; However, It Should Tighten Controls to Ensure Continued Accuracy.

Recommendation #1: The Office of Employee Relations and the City Attorney's Office should clarify the term FLSA premium pay in Municipal Code Section 3.36.020.3 C.

Administration's Response to Recommendation #1:

The Administration agrees with this recommendation. The Office of Employee Relations will work with the City Attorney's Office to bring forward an amendment to the definition of "compensation" to the Police and Fire Department Plan chapter of the Municipal Code specific to sworn employees in the Fire Department. The proposed amendment will clarify the definition of "FLSA Premium Pay".

Target Date for Completion: The Administration will work with the City Attorney's Office to complete this before the end of calendar year 2018.

☒ Green Light

☐ Yellow Light

☐ Red Light

☐ Refer to budget process

☐ Refer to Council Priority Setting

Recommendation #2: To improve transparency in how retirement benefits and contributions are calculated, the Administration should post a list of pay codes, along with their pensionable status, on its website that:

- a) Differentiates between retirement systems and tiers;**
- b) Includes an authoritative source of how the pay code became pensionable, such as the Municipal Code or a Memorandum of Agreement; and**
- c) The date the payroll system generated the report.**

Administration's Response to Recommendation #2:

The Administration agrees with this recommendation. The Office of Employee Relations will work with the Finance Department to generate a list of pay codes that can be published on the OER website. The list will clearly delineate between the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan.

Target Date for Completion: OER is currently working on this recommendation and should be able to post the list of pay codes by the end of June 2018. This posting will be updated should there be any changes to the negotiated premium pays.

- ☒ Green Light ☐ Yellow Light ☐ Red Light
☐ Refer to budget process
☐ Refer to Council Priority Setting

Recommendation #3: To ensure changes to PeopleSoft are implemented as intended, Finance's Payroll group should distribute copies of the "Request for PeopleSoft System Change" form to appropriate staff in the Office of Employee Relations, the City Attorney's Office, the Human Resource Information Systems team, and Information Technology Department prior to implementation.

Administration's Response to Recommendation #3:

The "Request for PeopleSoft System Change" form has been revised accordingly. The form will be completed by the Finance Department's Payroll group when a change to PeopleSoft is needed and sent for review by appropriate staff in the Office of Employee Relations, the City Attorney's Office, Human Resource Information Systems team, and Information Technology Department, with a copy to the Budget office, prior to implementation of any change to the PeopleSoft system.

Target Date for Completion: Completed, form has been revised.

- ☒ Green Light ☐ Yellow Light ☐ Red Light
☐ Refer to budget process
☐ Refer to Council Priority Setting

Recommendation #4: To guard against incorrect pay code changes, Finance's Payroll group should run a regular exception report from PeopleSoft to identify any changes in pay codes during the period, and this report should be reviewed by Payroll and the Office of Employee Relations.

Administration's Response to Recommendation #4:

Payroll holds a monthly inter-departmental meeting with the Office of Employee Relations, Human Resource Information Systems team, Information Technology Department, and Office of Retirement Services. Commencing in March 2018, Payroll will add a standing item "earning codes and changes" on the agenda for the monthly interdepartmental meetings. Payroll will run exception report from PeopleSoft to identify changes in pay codes and any findings, will be reviewed by Payroll and Office of Employee Relations every month.

Target Date for Completion: March 2018

☒ Green Light

☐ Yellow Light

☐ Red Light

☐ Refer to budget process


☐ Refer to Council Priority Setting

COORDINATION

This response has been coordinated with the City Attorney's Office and the City Manager's Budget Office

CONCLUSION

The audit report provides recommendations for tighter controls and more transparency around pensionable earnings. The Administration values these recommendations for opportunities to improve. The Finance Department and Office of Employee Relations would like to thank the City Auditor and staff for this operational review.


JULIA H. COOPER
Director of Finance

/s/
JENNIFER SCHEMBRI
Director of Employee Relations

For questions, please contact Grace Martinez, Deputy Director of Finance, Accounting at (408) 535-7034.



REQUEST FOR PEOPLESOFT SYSTEM CHANGE

Finance / Payroll

Change Requested by:

Department: Finance Department / Payroll
Requested by:
Approved by:
Approvers Title:
Date:

Form reviewed by: IT, HRIS, OER during coordination meeting on __/__/____

Description / Subject line of Memorandum:

Enter description of why change is being entered

| | |
|----------------------------------|--|
| PeopleSoft Module: | |
| Description: | |
| Earnings Code: | |
| Earnings Program Table: | |
| Time Reporting Code: | |
| TRC Program: | |
| Effective Date of Change: | |

Prepare / Review by: _____ Date:
Payroll Sr Accountant

Approved by: _____ Date:
Supervising Accountant

Approved by: _____ Date:
Principal Accountant

System Updated by: _____ Date:
Payroll Sr Accountant

System Verified by: _____ Date:
Payroll Accountant

Transaction audit (Payroll Wed): _____ Date:

CC: Budget Office, Attention: Operating Budget Coordinator