

Office of City Auditor

MANAGEMENT REVIEW OF THE DEFERRED COMPENSATION PLAN PROGRAM

July 20, 1999

Project Managers: **Scottie Veinot, CGFM**
Susan Kraght, CPA

City Auditor: Susan Cohen
Deputy City Auditor: David Jones

Auditors: Susan Baugh
Eileen Norton
Linneth Riley-Hall
Jerry Stein

Administrative Staff: Carolyn Yund
Theresa Velasquez

July 20, 1999

The Honorable Paul Schell
Seattle City Councilmembers
City of Seattle
Seattle, Washington 98104-1876

Dear Mayor Schell and City Councilmembers:

Attached is our report, Management Review of the Deferred Compensation Plan Program. We appreciate being invited by the Benefits Supervisor to conduct this review. We obtained comments on the draft report from ESD officials including the Chief Financial Officer, Accounting Director, Benefits Supervisor, and the Senior Benefits Analyst in charge of the Deferred Compensation program. When appropriate, we incorporated their comments into this final report.

If you have any questions regarding this report, please call me at 233-1093 or Scottie Veinot at 233-1094.

Sincerely,

Susan Cohen

Attachment

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Purpose

The City of Seattle offers employees the opportunity to enroll in a Deferred Compensation Plan. Today, over 5,900 current and past City employees participate in the Plan. We reviewed the Deferred Compensation Plan program at the request of the program's manager to help ensure that it was operating in compliance with laws and regulations and as efficiently and effectively as possible. In examining the program, we focused our attention on the City's:

- management of its contract with Fidelity;
- financial accounting and reporting; and
- administration of Plan and Trust Documents.

Background of the City of Seattle's Deferred Compensation Program and Plan

The Plan investment program is provided by Fidelity Investments Public Sector Services Company of Boston, Massachusetts. Fidelity offers over 20 investment fund choices to Plan participants. The features of Seattle's Plan are specified in a contract with Fidelity and follow rules established by Internal Revenue Service (IRS) Code 457 and 501(a), and ordinances passed by Seattle's City Council.

Seattle's Deferred Compensation Plan program began in November 1985. The Plan provides an opportunity for City of Seattle employees, both permanent and temporary, to invest their pre-tax salary into one or more investment options. (FICA and Medicare taxes are deducted from investment amounts, but no federal income tax is withheld.)

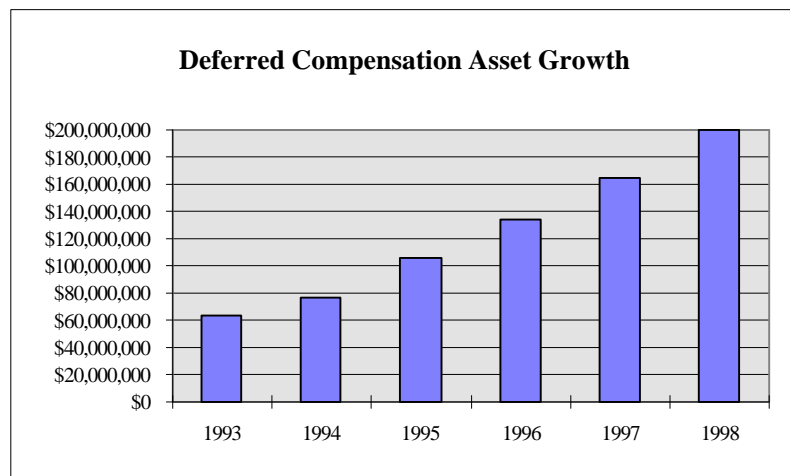
The Plan is funded by City employee payroll deductions. Plan participants communicate their investment decisions to Fidelity at any time, by transmitting account information over the Internet or by using toll free phone numbers to access the voice response system or to speak to Fidelity representatives.

The program provides Plan brochures, created by Fidelity, to every City employee who is hired. These brochures describe the Plan and the steps an employee must take to participate. There are also worksheets employees can use to determine the types of investments that best suit their financial goals with an acceptable degree of risk.

The Deferred Compensation Plan program offering helps the City obtain and retain competent employees who want a deferred compensation plan in their benefits package. The program's goal is to allow employees to set aside current earnings for use at a later date.

The Plan program is managed for the City by three staff members in the Benefits office within the Executive Services Department's Personnel Division: one full time and the others part-time. Additional City staff support the program in various capacities. For example, each City payday, the Payroll Office inputs new employee Plan deductions and changes in deduction amounts, and submits a wire transfer of employee Plan contributions to Fidelity. The City's automated data processing contractor, ADP, furnishes information via file transfer protocol (FTP) to Fidelity.

The Deferred Compensation Plan program is large and growing. The account balance, which approached \$200 million in 1998, increased over 3-fold in 5 years. The graph below depicts the asset growth since 1993. The City, through its automated data processing contractor, annually processes approximately 130,000 plan transactions, approximately 4,500 of which require some sort of manual activity involving many thousands of dollars.



A Trust Committee comprised of City employees and union representatives meets periodically to administer the program.¹ Benefits program personnel serve as a staff resource for the committee, answer questions from participants, review and determine pay-out eligibility, calculate catch-up deductions² and maintain records on all program participants.

Deferred compensation plans are one of the most valued and inexpensive benefits available to state and local government employees.³ The plans permit employees to voluntarily postpone receiving a portion of their salary until they retire or otherwise end their employment. At that time, employees receive the money they deferred either in a lump sum or according to a

¹ The Trust Committee began operations in January 1999. Our audit covered the activities of the Deferred Compensation Advisory Committee, which was the predecessor of the Trust Committee.

² "Catch-up" is contributing the difference between what was deferred and what was eligible to be deferred three years before declaring a normal retirement date.

³ "History of Section 457 Plans", National Association of Government Deferred Compensation Administrators.

withdrawal schedule they select. By receiving some of their salary in future years, employees can reduce current taxable income and current income taxes. By deferring payment of income tax until they actually receive the money, Plan participants may be taxed at a lower rate because their total income may be considerably lower at that time (especially in retirement).

In 1998, the City passed an ordinance, effective January 1, 1999, to bring the Plan into compliance with recent IRS 457 Plan requirements. Among its provisions, this ordinance:

- adopted a Plan and Trust Document;
- repealed obsolete ordinances;
- identified Plan Trustees and provided for their indemnification and insurance;
- defined the roles and responsibilities of the trustees; and
- provided for annual reporting.

Audit Scope and Methodology

In performing our audit, we researched program requirements and examined City files. We interviewed City employees from the Benefits Unit (Personnel Division, ESD), the Payroll Office (Accounting Division, ESD), City employees from various departments enrolled in the program, and individuals serving as Plan Trustees. We also interviewed and confirmed account information with Fidelity representatives. We focused our attention on the period January 1, 1998 through February 1, 1999, but expanded the time frame on some audit tests due to the limited activity within the audit period. Some testing included transactions dating back to 1989. Our audit was performed in accordance with generally accepted government auditing standards.

Audit Findings And Recommendations

This section of the audit report identifies the areas of improvement upon which the Deferred Compensation Plan program administrators should focus their efforts.

CONTRACT MANAGEMENT

Effective contract management is extremely important as it helps ensure that the City is getting the services and funds specified in a contract. Of the critical contract tasks we examined, we found five that needed special corrective action.

Plan Information and Literature

Fidelity provides Plan participants with considerable printed information, a toll-free number for participant inquiries, and Fidelity representatives periodically provide lunch time or one hour seminars on the Plan as well as individual appointments. The majority of the 20 City employees we contacted as part of our survey of customer service told us that they were pleased with the Plan information they received from Fidelity. However, there are four significant improvements needed:

1. Plan literature needs to disclose the \$23 annual fee Fidelity charges each participant and the impacts of that fee on the rate of return.
2. Literature on Plan mutual funds performance should include options available through the Seattle Federal Credit Union. Although the Credit Union options are not mutual funds, this information is important to participants who want to compare the return on available “safer” investments. Under its contract with the City, Fidelity is required to include information on these investment options along with mutual fund performance data.
3. A handout should be produced to advise Plan participants on the paperwork to file with the Plan in the event of divorce or marital separation.
4. The City needs to make better use of its InWeb or PAN Internet site to provide Plan information to City employees.

In addition, employees we surveyed thought the program could do a better job when contacted for information, particularly regarding such matters as how long one needs to wait after requesting enrollment before deductions will begin, what fees are charged, how to handle divorce issues, and how catch-up provisions work. After further discussion with Benefits Unit staff, we discovered that these questions may have surfaced due to callers’ misunderstanding of the Plan information that is provided by the Benefits Unit versus Fidelity. These issues should be explored in future customer satisfaction surveys.

We recommend that:

- a Benefits Unit person be assigned to ensure that information on fees and alternative investments is included in future Plan literature and clearly communicated;
- the Benefits Unit develop a handout to identify specific steps an employee must take in case of divorce or legal separation;
- the Benefits Unit create a web site with information such as Plan features and contact information for City and Fidelity representatives; and
- the web site will include: program regulations, Trust Committee member list with contact information, investment options, and a checklist of what to do in various situations, i.e. retirement, divorce, termination, etc.

Benefits Unit Response

The first item has already been completed. The remaining items are included in the Benefits Unit work plans and will be accomplished as soon as possible.

Holding Fidelity To Contract Requirements

Fidelity needs to make provisions to assure the City that it can fulfill its contractual obligations at all times. The City may want to require Fidelity to provide the City quarterly participant fee statements within a reasonable time after the end of the quarter. For example, the City did not receive the third quarter 1998 statement (due October 20) until February 1999. The City should consider creating a schedule for Fidelity to remit funds owed the City similar to the report time requirement. The City's contract with Fidelity does not specify penalties or any form of relief for the City in the event that Fidelity does not comply with its contractual requirements. If Fidelity is unwilling to meet its requirements, the City should re-bid the contract immediately.

Fidelity is not calculating catch-up amounts as required by the contract. Benefits staff stated that "Fidelity representatives were instructed since the inception of the plan to refer catch-up calls to the Benefits Unit. Benefits staff explain catch-up to participants, send them the catch-up form, and set up the deduction."

We recommend that:

- the Benefits Unit require Fidelity to submit its quarterly report in a more timely manner, and that this statement be reconciled quarterly;

- the Benefits Unit create a timeline and schedule of funds owed for Fidelity to remit funds to the City. It should be further noted that when the City receives the notice of funds, a reasonableness check should be performed to determine the accuracy of the remittance;
- the Benefits unit modify the City's contract with Fidelity to specify penalties or form of relief for the City in the event that Fidelity does not comply with its contractual requirements; and
- Fidelity perform catch-up calculations as required in the contract.

Benefits Unit Response

These issues will be addressed when the contract is re-bid.

Contract Amendments

Basic contract administration requires that both parties agree to all contract changes in writing prior to implementation. In the case of the City's contract with Fidelity, the two parties agreed, in April 1998, to increase the annual fee paid by participants to the City to \$11 in return for eliminating a requirement that Fidelity maintain an office for the Plan in Seattle. The two parties did not execute a signed amendment until February 1999. Without a valid and properly executed contract amendment, the City would not be appropriately protected in the event of a legal dispute.

We recommend that: in the future, the Benefits Unit execute formal contract amendments before changing contract terms.

Benefits Unit Response

We concur with the audit recommendation and have completed a contract amendment to address this situation. In the future we will issue contract amendments promptly.

Fidelity's Adherence to Customer Service Requirements

Based on our interviews with 20 City employees, Fidelity appears to be providing adequate customer service, with particular satisfaction on the part of employees who have attended one or more of Fidelity's lunch time or one hour seminars. The contract requires Fidelity to provide a wide range of customer service functions, including telephone services, confirmation of transactions, and enrollment services.

There are no recommendations for this area. No audit response is required.

Insurance Administration

Fidelity did not have evidence of insurance on file prior to our audit. However, in February 1999, Fidelity provided the information to the City's Risk Manager. The City's current contract with Fidelity and City Ordinance 119159 require the filing of such evidence. In addition, the City is not completely in compliance with the Plan And Trust Document which requires the City to purchase insurance to cover Plan Trustees. The 1998 ordinance adopting the restated Plan document directed the Risk Manager to "provide adequate insurance coverage for the City's indemnification obligations as provided in the Plan and Trust Document."

We recommend that: the Risk Manager with the assistance of the Benefits Unit ensure that proper insurance coverage is in place for its trustees, some of whom are not City employees. This will be accomplished no later than September 1, 1999.

Benefits Unit Response

We concur with the audit recommendation. The Law Department and Risk Management Office are currently studying this issue.

FINANCIAL ACCOUNTING

Accurate financial records and reporting in accordance with financial standards provide assurance that programs are performing as expected and are meeting their business objectives. Of the items we reviewed, we noted the following area that required attention:

Reconciling Records: Payroll

Prior to July 1998, the Payroll Office had not reconciled Fidelity's records to City records in a timely fashion. Hence, the City had no means of insuring that Fidelity credited all pay deferrals.

We recommend that: The Payroll Office perform a monthly reconciliation of Fidelity's statements by comparing them to the deduction amounts withheld from employees by ADP, the City's data processing contractor. An accounting supervisor will review and approve this reconciliation.

Payroll Response

We currently are performing this reconciliation and approval as requested in the audit.

Reconciling Records: Benefits Unit

The Benefits Unit has no means of monitoring the amounts charged to Plan participants from their location. The best method the City has to monitor Fidelity for plan charges is to have a periodic audit conducted at Fidelity corporate headquarters.

We recommend that: the Benefits Unit schedule an audit to be conducted at the Fidelity site to provide assurance to the City that Fidelity has systems in place to comply with their contract with the City.

Benefits Unit Response

The Benefits Unit will discuss this audit recommendation with the Trustees and act at their direction.

Reconciling Records: Individual Plan Participants

Most employees with whom we spoke do not carefully review their account statements. Instead, they assume the City is monitoring their account and performing oversight. If the City could depend on employee plan participants to review their quarterly statements carefully and report discrepancies, the problem would not be worrisome. Unfortunately, participants do not appear to do this consistently.

There are no recommendations associated with this item.

PLAN AND TRUST DOCUMENT ADMINISTRATION

It is essential that the Plan be administered in an effective manner and that the committee and staff work together to assure program needs have been addressed. Of the Plan and Trust document administration areas we reviewed, we found six that we believe need to be addressed to ensure adequate management of the Plan and Trust administration requirements.

Limitation of Participant Deferrals

Plan rules limit participants' annual income deferrals to the lower of \$8,000 or one-third of annual compensation. However, under catch-up provisions⁴, in the three years prior to the calendar year in which they are eligible for an actuarially unreduced retirement benefit, a participant may annually defer up to \$15,000. During the three-year catch-up period, the participant may not contribute more than \$22,500 in catch-up deductions, or the amount they were eligible to contribute in previous years but did not, whichever is less. Participants may not utilize these catch-up provisions in their year of retirement. To maintain a qualified deferred compensation plan, the City must adhere to deferral limits, including catch-up deferrals. We noted that the Benefits Unit and Accounting did not have documented, developed procedures for catch-up processing.

We recommend that: the Benefits Unit and Accounting jointly develop a procedure for catch-up deferrals. The procedure will cover calculating limitations, coding accounts, and refunding improper deferrals.

Benefits Unit Response

This has already been accomplished.

Accounting Response

The Accounting Director will discuss this recommendation with the Benefits Unit.

Expenses of Administration

The Deferred Compensation Plan program was intended to be self-financing. Currently, the City receives approximately \$65,000 from participant fees to cover its administrative costs. According to the Plan and Trust Document, “the costs of carrying out the Plan will be borne by those participating, through reasonable fees agreed to by the Trust Committee for administrative, record-keeping, investment and other services performed and for appropriate

⁴ “Catch-up” is contributing the difference between what an employee deferred and what the employee was eligible to defer three years before declaring a normal retirement date.

expenses incurred.” However, in Table 1, we estimate the City spends at least double the amount it receives to administer the program.⁵

Table 1

Deferred Compensation Program Costs

Full Time Clerical	\$48,000
Part-time Clerical (‘99 Budget item)	\$6,500
Half-time Administrator	\$35,700
15% Manager (estimate)	\$9,800
Overhead 19% (‘99 budget)	\$19,100
Consultant	\$8,000
Legal Services (estimate)	\$10,000
Accounting Services (estimate)	\$20,000
Bank Fees (estimate)	\$100
Trustee insurance (no estimate available)	unknown
Total Program Costs	\$158,000

Amount City Currently collects to cover costs (estimates) \$65,000

We recommend that: The City redesign the fee structure to re-coup its costs.

City Chief Financial Officer Response

The City’s Chief Financial Officer believes that the program should be self-financing for its marginal costs.

Documentation of Hardship Withdrawals

The program allows participants to withdraw funds from their personal investment account to meet an "unforeseen emergency," which the Plan and Trust Document defines as:

“...a severe financial hardship to the Participant resulting from a sudden and unexpected illness or accident to the Participant or a dependent, loss of the Participant’s property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of an event beyond the Participant’s control.”

The Plan and Trust Document forbids an emergency withdrawal when:

⁵ Participant reimbursements come from the annual fee of \$23 that participants pay, \$11 of which Fidelity remits to the City.

“...Participant’s hardship may be relieved through reimbursement, compensation by insurance or otherwise; a sale of the Participant's assets without causing severe financial hardship; or suspending the Participant’s deferrals.”

The Benefits Unit refers requests to the Hardship Committee which decides hardship requests on a case by case basis. The Benefits Unit Plans to significantly improve the management over hardship cases by:

- maintaining consistent documentation to show that other sources of funds were not available to the participant;
- ensuring the Trust Committee understands the criteria to use as guidelines for considering requests; and,
- preparing a handout that explains hardship requests and criteria.

We recommend that:

- the Benefits Unit ensure that participants requesting withdrawal of funds to meet unforeseen emergencies provide documentation not only of the emergency but also of the unavailability of alternative sources of funds; and
- the Benefits Unit discuss with the Trust Committee the “gray” areas within the IRS rules and have the committee determine the direction the plan should take regarding these policy issues. The IRS rules governing hardship withdrawals are found in Treasury Regulation 1.457-2(h)(4).

Benefits Unit Response

These items have been accomplished.

Annual Plan Report

The Benefits Unit is not prepared to produce the annual report on the operation and condition of the Plan required by the new Plan And Trust Document or City Ordinance 119159. The Benefits Unit has neither a strategy nor a format for producing this report. Nor has the Benefits Unit budgeted for or set up a cost collection system for accurately capturing the receipts and disbursements for administering the Plan, although the Plan and Trust Document requires the report to include a schedule of receipts and disbursements.

We recommend that:

- an annual plan report on the operation and condition of the Plan be produced;
- the Benefits Unit establish an administrative budget that reflects the total cost of the Plan, and charge all Plan labor and expenses to general ledger accounts that correspond to the Plan budget; and
- the Benefits Unit draft a report format for Trustee approval.

Benefits Unit Response

This audit recommendation will be presented to the Trustees.

Customer Satisfaction Survey

We reviewed the most recent customer satisfaction survey performed in 1996 while PEBSCO was the service provider. The survey asked no questions that would reveal how well the Benefits Unit was performing. Moreover, the results were tabulated by the Benefits Unit which reduced the likelihood of candid responses.

We recommend that: the Benefits Unit have a customer survey performed. We believe this survey should be performed under the monitoring of the Trust Committee and should ask questions that specifically address customer interaction and satisfaction with the Benefits Unit performance related to the administration of the Deferred Compensation Plan program.

Benefits Unit Response

This audit recommendation will be presented to the Trustees and we will act at their direction.

Trust Committee

Starting in January 1999, the City established a Trust Committee to govern the Deferred Compensation Plan program administration. The committee members we interviewed reported that they were generally satisfied with the reports they received from Fidelity and the support received from the Benefits Unit.⁶ To strengthen the Committee's oversight of the program and comply with the spirit of open meetings, the Benefits Unit plans to:

⁶ Committee members also liked the reports prepared by a consultant because these reports helped the members fulfill their monitoring role.

- announce Trust Committee meetings to all employees and hold them in a place easily accessible to employees;
- ensure that meetings have an agenda;
- ensure that the minutes of the Trust Committee meeting document all decisions made;
- develop a defined, consistent policy making process for the Committee;
- have the Trust Committee play an active role in the decisions regarding trust administration;
- ensure better attendance at meetings by Committee members; and
- ensure Committee members have enough information to monitor the Plan.

We recommend that:

- Trust Committee meetings be announced to all City employees and held in an easily accessible location;
- an agenda and minutes documenting decisions be kept for all committee meetings;
- the Committee develop a mechanism for making and recording its policy decisions, and that it plays an active role in the decisions surrounding trust administration;
- the Committee ensures that it obtains from Fidelity all the information necessary to monitor Fidelity's performance and pricing; and
- the Committee monitor the Benefits Unit's response to our audit's recommendations and determine whether the responses are adequate to ensure the plan is properly managed.

Trust Committee Chair Response

The audit recommendations will be presented to the Trustees for consideration.

Major Policy Questions

In reviewing the Deferred Compensation Plan program, we identified two major policy questions:

1. Should the Deferred Compensation Plan program continue to be required to cover its own costs?

The City's Chief Financial Office believes that the program should be self-financing for its marginal costs.

2. Should the City or the Plan participant ultimately be responsible for ensuring Fidelity correctly credits individual accounts and processes other account activity properly?

Clarifying Responsibility Currently, there is ambiguity about who is ultimately responsible for ensuring Fidelity's accuracy regarding individual accounts. We found that neither the City nor individual employees understand this responsibility, and that neither thoroughly reviews account statements. The City either needs to clearly accept this responsibility and manage it more thoroughly or, alternatively, alert and educate employees that they need to monitor their own accounts.

The City's Chief Financial Officer believes this should be the participants' responsibility. However, he also stated that the City and Fidelity should periodically remind employees that it is their responsibility to review account statements.