

Audits & Risk Management Committee

Item Number 8 – Open Session

Subject: 2021 Internal Audit Plan Risk Assessment

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Item Type: Information

Date & Time: November 6, 2020 – 10 minutes

Attachment: 1

PURPOSE

This item summarizes Audit Services’ 2021 annual risk assessment results. The purpose of the annual risk assessment is to identify and assess the risks of achieving the organizations objectives and to propose audits for Calendar Year 2021.

SUMMARY

As required by the *International Standards for the Professional Practice of Internal Auditing*, Audit Services must establish risk-based plans to determine the priorities of the internal audit activity consistent with the organization’s goals and objectives. Risk assessment is “a systematic process for assessing and integrating professional judgements about probable adverse conditions and/or events.” Audit Services conducts an annual risk assessment using two different models, one for employer audits and another for internal audits.

Employer Audits Risk Assessment

The following diagram illustrates the risk assessment and audit plan preparation process for Employer audits.



The employer risk assessment begins with a discussion of potential employer, member, and compensation spiking risk areas. The employer audit team obtains and analyzes reported member and payroll data during the last two fiscal years to determine the potential risk factors. Audit Services conducted a risk assessment of 1,789 employers who report member census and payroll data to CalSTRS. This information is stored within the CalSTRS corporate database: the START system. The Los Angeles Unified School District (LAUSD) data was obtained and separated from this risk assessment process due its size. All other employers are included in the risk assessment universe and considered separate auditable entities. The LAUSD's data will be analyzed separately in order to perform up to three limited scope reviews of the LAUSD.

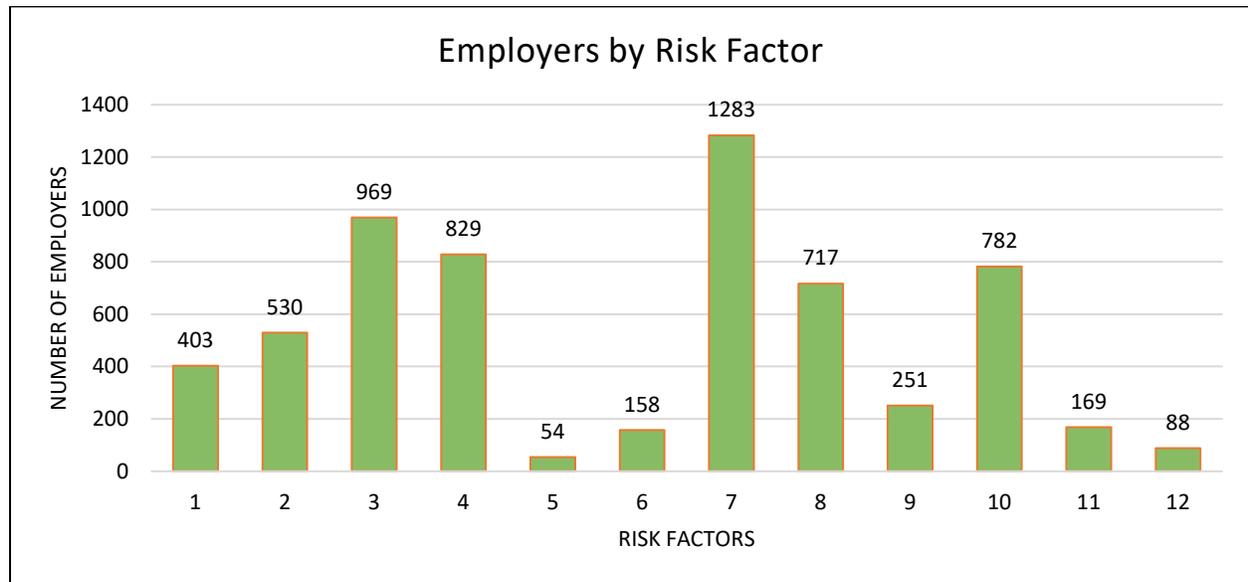
Audit Services analyzed, and ranked the employers using 12 predetermined risk factors. For each risk factor, employers received a weighted score up to the maximum value assigned to each risk factor (1 to 5, with five being the highest) based on the potential impact and occurrence. Of the 12 risk factors, three are associated with potential spiking, and three are related to high amounts of reported special compensation. The summation of the risk factor values determines the total score of each employer. See Attachment 1 for a comprehensive list of risk factors, assigned risk values, and descriptions. The following is a summary of the 12 risk factors applied to each employer:

Risk Factors:

1. Retirees with large increases in annual compensation while active
2. Retirees with high annual earnings while active
3. Members with large amounts of special compensation
4. Active members large increases in compensation
5. Employers issuing one-time payments
6. Retirees with excess sick leave days
7. No prior audits in the last five years
8. Active members nearing retirement with large increases in compensation
9. Retirees with sick leave exceeding possible accumulated leave earned
10. PEPRA members with high special compensation
11. Employers with more than 750 active members
12. New Employers as of July 1, 2015

The individual risk factor scores were totaled and applied to each employer. Table 1 shows the number of employers that received a score for each risk factor. For instance, 969 employers received a score for Risk Factor 3 – Members with large amounts of special compensation.

Table 1 – Number of Employers by Risk Factors



The employers are then divided into three risk categories (high, medium, and low) based upon total score. For a summary of the risk assessment results, see Table 2.

Table 2 – Number of Employers by Risk Categories

School/Employer	High-Risk	Medium-Risk	Low-Risk	Total
Community Colleges	59	12	1	72
K12 Schools	324	340	271	935
K12 Charter Schools	19	303	371	693
State Agencies (Dept. of Ed, Corrections, and Commissions)	0	4	15	19
Regional Occupational Centers	1	7	8	16
County Superintendents	29	21	4	54
Grand Total	432	687	670	1789

This risk ranking process provides an equitable method of prioritizing each employer for audit coverage. Audit services will select 20 full-scope audits using the following methodology:

- 65 percent of audits will be selected from High Risk = 13 (13/20)
 - 3.0 percent of entities assessed as high risk will be audited (13 audits / 432 employers)
- 25 percent of audits will be selected from Medium Risk = 5 (5/20)
 - 0.7 percent of entities assessed as medium risk will be audited (5/687)
- 10 percent of audits will be selected from Low Risk = 2 (2/20)
 - 0.3 percent of entities assessed as low risk will be audited (2/670)

Limited Scope Reviews

Over the past six years, Audit Services’ full-scope audits found that employers commonly misreported special compensation (55% of employers audited), unused sick leave (33% of employers audited), and post-retirement earnings (35% of employers audited). Therefore, Audit Services plans to perform limited scope reviews focused on special compensation, unused sick leave and post-retirement earnings. Audit Services will utilize data analytics to select employers with a greater likelihood of misreported special compensation, unused sick leave and post-retirement earnings.

Proposed Employer Audits

Based on available staff resources, Audit Services plans to conduct 20 full-scope audits and 86 limited scope audits focused on Special Compensation, Unused Sick Leave and Post-Retirement Earnings for a total of 106 audits during calendar year 2021. Audit Services will also continue to consider special requests and referrals.

Internal Audits Risk Assessment

This year, Audit Services collaborated with Enterprise Compliance Services and Enterprise Risk Management in the annual risk assessment. Audit Services identified the auditable activities and evaluated the key risks in order to perform ranking. The figure below illustrates the approach to the internal audit risk assessment.

Figure 1: Internal Audit Risk Assessment and Audit Plan Process

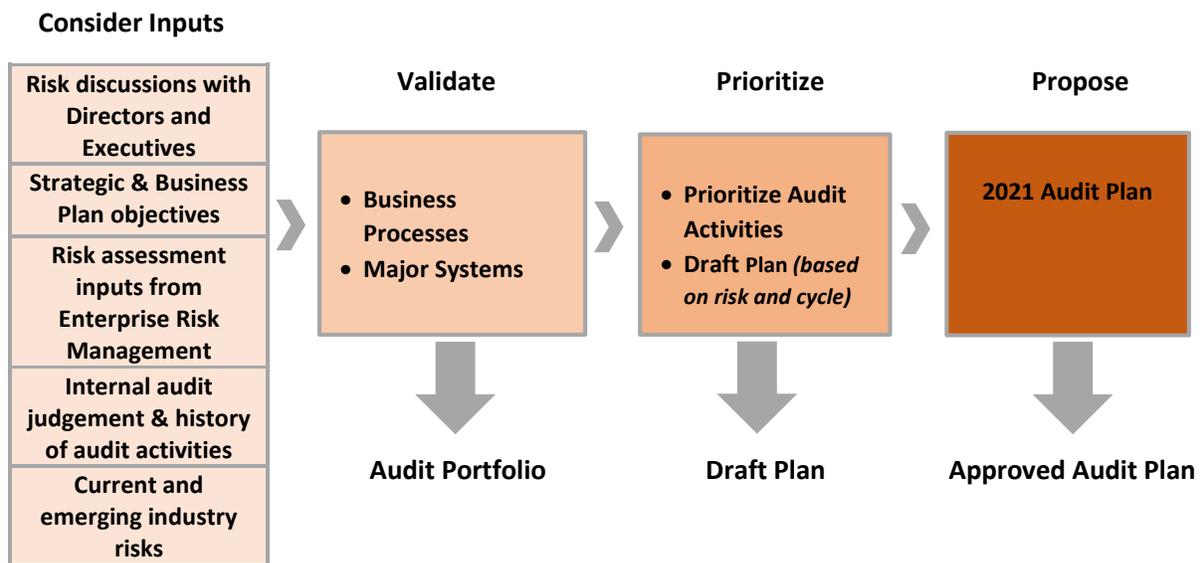


Figure 1 describes internal and external inputs considered in development of the audit portfolio which is validated and prioritized to complete the draft audit plan. The draft audit plan is approved by the Audits and Risk Management (ARM) Committee which results in the final audit plan.

Proposed Internal Audits

Audit Services sorted the risk portfolio in descending order based on its aggregate score and identified the top auditable areas. Audit Services then evaluated the top auditable activities, considering resources and timing to determine which should be included in the 2021 Proposed Audit Plan. Audits of investment asset classes are performed on a rotating cycle and investment programs are risk ranked. Audit Services contracts with external audit firms to conduct investment and information technology audits because of the specialized knowledge and expertise required. The risk map below demonstrates the results of the operational evaluation.

Figure 2: Risk Map of Top Auditable Areas

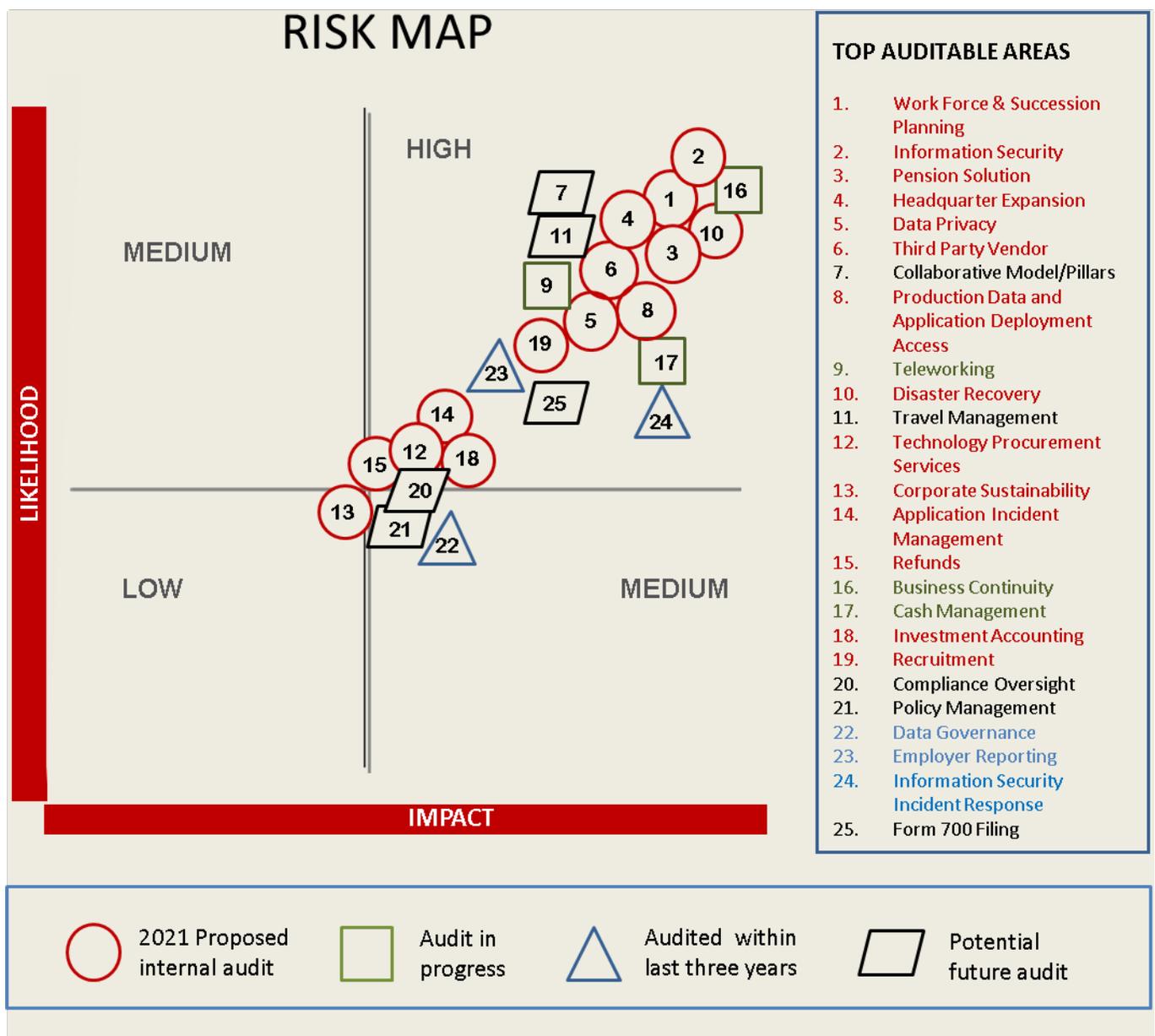


Figure 2 describes the top 25 auditable areas plotted by likelihood and impact.

RECOMMENDATION

Audit Services seeks input from the ARM Committee on the risks identified and proposed audits. Audit Services utilizes the results of the risk assessments in the development of the 2021 risk-based audit plan (Agenda Item 9).

ATTACHMENT(S)

Attachment 1 – Employer Audit Risk Assessment Factors

Table 1 – Employer Audit Risk Assessment Factors

	Risk Factors	Risk Scoring Range*	Description
1	Retirees with increased Annual Compensation Earnable (ACE) while active	0 to 4	Employers with members who retired during the last two years and received over 10 percent increase in compensation during fiscal year 2018-19 or 2019-20.
2	Retirees with high ACE	0 to 5	Employers with retirees who retired during fiscal year 2018-19 or 2019-20 who have annual compensation earnable greater than \$120,000 (while active).
3	Special compensation	0 to 4	Employers reported members' special compensation of \$2,500 or more during fiscal year 2018-19 or 2019-20.
4	Active members with ACE increases	0 to 3	Employers reported active members with increases greater than 20 percent in annual compensation earnable during fiscal year 2018-19 or 2019-20.
5	One-Time Payments	0 to 5	Employers with high level of one-time payments over \$1,200 during the 2018-19 or 2019-20 fiscal year.
6	Retirees reported with excess sick leave days	0 to 3	Employers with members who retired during fiscal year 2018-19 or 2019-20 with excess sick leave.
7	Prior audits	1	Employers not audited during the last six years.
8	Active members eligible to retire with ACE increases	0 to 4	Employers reported active members with birthdays prior to January 1, 1965, that had increases greater than 10 percent during fiscal year 2018-19 or 2019-20.
9	Retirees with high unused sick leave days reported	0 to 3	Employers who reported retirees total unused sick leave days greater than basic service credit multiplied by 10 that retired during fiscal year 2018-19 or 2019-20.
10	PEPRA members with high special compensation	0 to 3	Employers with PEPRA members with reported special compensation of \$1,200 or more in fiscal year 2018-19 or 2019-20.
11	Number of active members reported to CalSTRS	0 to 3	Employers with active members of 750 or more during fiscal year 2019-20.
12	New Employer	2	New employer as of July 1, 2015.

* Risk Scoring Range is weighted based on the number of members and/or dollar amounts.