

CALIFORNIA STATE LOTTERY

Audit Report

Payroll Process and Transactions

July 1, 2016, through April 30, 2019



BETTY T. YEE
California State Controller

March 2021



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California State Controller

March 1, 2021

Alva Vernon Johnson, Director
California State Lottery
700 North Tenth Street
Sacramento, CA 95811

Dear Mr. Johnson:

The State Controller's Office audited the California State Lottery's (Lottery) payroll process and transactions for the period of July 1, 2016, through April 30, 2019. The purpose of the audit was to determine if the Lottery maintains an adequate system of internal controls over its payroll process and processed payroll and payroll-related disbursements and leave balances accurately and in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

Our audit found that the Lottery lacked adequate segregation of duties and compensating controls over the payroll process, resulting in improper and questioned payments; granted inappropriate keying access to the State's payroll system; did not implement adequate controls to limit excessive leave balances; and did not properly administer salary advances.

If you have any questions, please contact Mr. Finlayson by telephone at (916) 324-6310 or by email at afinlayson@sco.ca.gov.

Sincerely,

Original signed by

MICHAEL REEVES, CPA
Acting Chief, Division of Audits

JLS/as

cc: Gregory Ahern, Chair

California State Lottery Commission

Nathaniel Kirtman III, Commissioner

California State Lottery Commission

Keetha Mills, Commissioner

California State Lottery Commission

Peter Stern, Commissioner

California State Lottery Commission

Harjinder Chima, Chief Deputy Director

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State Controller's Office

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Audit Report

Summary

The State Controller's Office (SCO) audited the California State Lottery's (Lottery) payroll process and transactions for the period of July 1, 2016, through April 30, 2019. The purpose of the audit was to determine if the Lottery maintains an adequate system of internal controls over its payroll process and processed payroll and payroll-related disbursements and leave balances accurately and in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

Our audit found that the Lottery lacked adequate segregation of duties and compensating controls over the payroll process, resulting in improper and questioned payments; granted inappropriate keying access to the State's payroll system; did not implement adequate controls to limit excessive leave balances; and did not properly administer salary advances. Further details of these findings are described in the Conclusion, and Findings and Recommendations sections of this report.

Background

On November 6, 1984, California voters passed Proposition 37, the California State Lottery Act of 1984 (Lottery Act), which authorized the creation of a state-operated lottery. The Lottery Act is found in Chapter 12.5, section 8880 et seq., of the Government Code. The Lottery Act created the California State Lottery Commission (Commission) and gave it broad powers to oversee the Lottery's operations. The purpose of the Lottery Act is to provide supplemental money to benefit public education without the imposition of additional or increased taxes.

The Lottery has eight divisions: Executive, Finance, Human Resources, Operations, Public Affairs and Communications, Security and Law Enforcement, Information Technology Services, and Sales and Marketing. As of October 1, 2020, the Lottery has 909 budgeted positions; staff are located at Lottery Headquarters, two distribution centers, and nine district offices.

In 1979, the State of California adopted collective bargaining for state employees. This created a significant workload increase for the SCO's Personnel and Payroll Services Division (PPSD), as PPSD was the State's centralized payroll processing center for all payroll-related transactions. PPSD decentralized the processing of payroll, allowing state agencies and departments to process their own payroll-related transactions. The Lottery's Transactions and Payroll Unit in the Human Resources Division has the responsibility of processing personnel transactions, payroll, leave balances, and benefits.

Pursuant to Government Code (GC) section 8880.46.6, the SCO may conduct special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the Commission.

GC section 12410 states, in part:

The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment.

In addition, GC section 12411 stipulates that “. . . the Controller shall suggest plans for the improvement and management of revenues.”

Furthermore, GC section 12476 states, “The Controller may audit the uniform state pay roll system, the State Pay Roll Revolving Fund, and related records of state agencies within the uniform State’s payroll system, in such manner as the Controller may determine.”

Objectives, Scope, and Methodology

The objectives of the audit were to determine whether the Lottery:

- Maintained adequate and effective internal controls over its payroll process;
- Processed payroll and payroll-related disbursements and leave balances accurately and in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures; and
- Administered salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

The audit period was July 1, 2016, through April 30, 2019.

To achieve our audit objectives, we:

- Reviewed State and the Lottery’s policies and procedures related to the payroll process to understand the Lottery’s methodology for processing various payroll and payroll-related transactions;
- Interviewed the Lottery’s payroll personnel to gain an understanding of the Lottery’s internal controls and methodology for processing payroll and payroll-related transactions;
- Selected the following transactions recorded in the State’s payroll database using statistical sampling (see the Appendix), judgmental selection, and targeted selection based on risk factors and other relevant criteria:
 - 11 employees with keying access to the State’s payroll system;
 - 45 out of 25,977 (\$226,378 out of \$131,774,771) regular pay transactions;
 - 129 out of 1,639 (\$251,601 out of \$1,072,513) overtime transactions;
 - 66 out of 133 (\$948,295 out of \$1,532,296) lump sum transactions;

- 115 out of 3,615 (\$230,165 out of \$6,886,700) 9G bonus pay transactions;
- 34 out of 1,216 (\$16,704 out of \$331,789) holiday credit accrual transactions;
- 31 out of 69 (\$480,624 out of \$903,755) excess vacation and annual leave balances;
- Five out of 237 (\$38,628 out of \$1,500,000) G1 payment transactions;
- Analyzed and tested the selected transactions, and reviewed relevant files and records to determine the accuracy of payroll and payroll-related payments, accuracy of leave transactions, adequacy and effectiveness of internal control over the payroll process, and compliance with collective bargaining agreements and state laws, regulations, policies, and procedures; and
- Reviewed all eight (\$10,935) salary advance transactions to determine whether the Lottery administered and recorded them in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

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 review of internal control to gain an understanding of the Lottery's payroll processes. We did not audit the Lottery's financial statements.

Conclusion

Our audit determined that the Lottery:

- Did not maintain adequate and effective internal controls over its payroll process. We found the following deficiencies in internal control over the payroll process that we consider to be material weaknesses:¹
 - Inadequate segregation of duties and compensating controls over payroll transactions (see Finding 1);

¹ A deficiency in internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with provisions of laws, regulations, or contracts on a timely basis. Control deficiencies, either individually or in combination with other control deficiencies, may be evaluated as significant deficiencies or material weaknesses. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with provisions of laws, regulations, or contracts will not be prevented, or detected and corrected, on a timely basis. A significant deficiency over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with provisions of laws, regulations, or contracts that is less severe than a material weakness, yet important enough to merit attention from those charged with governance.

- Inappropriate keying access to the State's payroll system (see Finding 2);
 - Failure to implement controls to limit the accumulation of vacation and annual leave balances, resulting in liability for excessive balances (see Finding 3);
 - Inadequate controls to ensure that separation lump-sum payments were calculated correctly and paid in a timely manner, resulting in improper and late payments (see Finding 4);
 - Inadequate controls to ensure that overtime payments were calculated correctly, supported, and granted to eligible employees, resulting in improper and questioned payments (see Finding 5);
 - Inadequate controls to ensure that bonus payments were calculated correctly and granted to eligible employees, resulting in improper payments (see Finding 6);
 - Inadequate controls to ensure that holiday credits were granted to eligible employees and supported with documentation, resulting in improper and questioned credits (see Finding 7); and
 - Inadequate controls to ensure collection of salary advances in a timely manner, resulting in failure to recover outstanding amounts (see Finding 8).
- Did not process payroll and payroll-related disbursements and leave balances accurately and in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures. We found the following instances of noncompliance:
 - Excessive vacation and annual leave balances with a value of at least \$903,755 as of March 31, 2019 (see Finding 3).

Although an October 20, 2020 directive from the California Department of Human Resources (CalHR) does not affect the dollar value of this finding, we are disclosing this directive because it affects our recommendation. CalHR has directed departments to immediately suspend policies that require leave balances to be reduced below the limit, and that require employees to implement leave-reduction plans. This suspension will be in effect until the 2020 Personal Leave Program (2020 PLP) ends or July 1, 2022, whichever is sooner;
 - Improper and late payments made for employee separation lump-sum pay (see Finding 4), improper and questioned payments made for overtime pay (see Finding 5), improper payments made for bonus pay (see Finding 6); and improper and questioned holiday credits (see Finding 7), costing an estimated net total of \$127,477 (see Findings 4, 5, 6, and 7); and
 - Did not administer salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures for three salary advances, totaling \$2,500 that remained outstanding as of April 30, 2019 (see Finding 8).

See the Schedule for a summary of the audit findings.

**Follow-Up on Prior
Audit Findings**

The SCO previously performed an audit of the Lottery's payroll process for the period from July 1, 2012, through June 30, 2015, and issued a report on February 24, 2017. The audit report included findings regarding keying access, lump-sum payments, and overtime. Based on the work performed during our current audit, we noted similar findings (see Findings 2, 4, and 5).

**Views of
Responsible
Officials**

We issued a draft audit report on November 3, 2020. Alva Vernon Johnson, Director, responded by letter dated November 16, 2020 (Attachment), agreeing with the audit results. This final audit report includes the Lottery's response.

Restricted Use

This report is intended for the information and use of the Lottery, the Commission, CalHR, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record, and is available on the SCO website at www.sco.ca.gov.

Original signed by

MICHAEL REEVES, CPA
Acting Chief, Division of Audits

March 1, 2021

Schedule— Summary of Audit Findings

Audit Area Tested	Method of Selection	Number of Units of Population	Dollar Amount of Population	Number of Selections Examined	Selection Unit	Dollar Amount of Selections Examined	Total Dollar Amount of Known and Likely Issues	Finding Number
Segregation of duties	N/A	N/A	N/A	N/A	N/A	-	-	1
System access	Targeted	11	-	11	Employee	-	-	2
Excess vacation and annual leave	Statistical	69	\$ 903,755	31	Employee	\$ 480,624	\$ 903,755	3
Separation lump-sum pay	Statistical and targeted	133	1,532,296	66	Employee	948,295	691	4
Overtime pay	Statistical and targeted	1,639	1,072,513	129	Transaction	251,601	33,395	5
9G bonus pay	Statistical and targeted	3,615	6,886,700	115	Transaction	230,165	80,222	6
Holiday credit	Targeted	1,216	331,789	34	Transaction	16,704	13,169	7
Salary advances	Targeted	8	10,935	8	Transaction	10,935	2,500	8
Total			<u>\$ 10,737,988</u>			<u>\$ 1,938,324</u>	<u>\$ 1,033,732</u>	

Findings and Recommendations

FINDING 1— Inadequate segregation of duties and compensating controls over payroll transactions

The Lottery lacked segregation of duties within its Transactions and Payroll Unit to ensure that only valid and authorized payroll transactions were processed. The Lottery also failed to implement other controls to compensate for this risk.

GC sections 13400 through 13407 require state agencies to establish and maintain internal controls, including proper segregation of duties and an effective system of internal review. Adequate segregation of duties reduces the likelihood that fraud or error will remain undetected by providing for separate processing by different individuals at various stages of a transaction and for independent reviews of the work performed.

Our audit found that Transactions and Payroll Unit staff performed conflicting duties. Staff members performed multiple steps in processing payroll transactions, including entering data into the State's payroll system; auditing employee timesheets; reconciling payroll, including reconciling system output to source documentation; reporting payroll exceptions; and processing adjustments. For example, staff members keyed in regular and overtime pay and reconciled the master payroll, overtime, and other supplemental warrants. The Lottery did not have compensating controls, such as a periodic supervisory review, to mitigate the risks associated with such a deficiency.

The lack of adequate segregation of duties and compensating controls has a pervasive effect on the Lottery payroll process, and impairs the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. These control deficiencies, in combination with other deficiencies discussed in Findings 2 through 8, represent a material weakness in internal control over the payroll process such that there is a reasonable possibility that noncompliance with provisions of laws, regulations, or contracts will not be prevented, or detected and corrected, on a timely basis.

Good internal control practices require that the following functional duties be performed by different work units, or at minimum, by different employees within the same unit:

- *Recording transactions* – This duty refers to the record-keeping function, which is accomplished by entering data into a computer system.
- *Authorization to execute* – This duty belongs to individuals with authority and responsibility to initiate and execute transactions.
- *Periodic review and reconciliation of actual payments to recorded amounts* – This duty refers to making comparisons of information at regular intervals and taking action to resolve differences.

Recommendation

We recommend that the Lottery:

- Separate conflicting payroll function duties to the greatest extent possible. Adequate segregation of duties will provide a stronger system of internal control whereby the functions of each employee are subject to the review of another.

If it is not possible to segregate payroll functions fully and appropriately, the Lottery should implement compensating controls. For example, if the Transactions and Payroll Unit staff member responsible for recordkeeping also performs a reconciliation process, then the supervisor should perform and document a detailed review of the reconciliation to provide additional control over the assignment of conflicting functions. Compensating controls may also include dual authorization requirements and documented reviews of payroll system input and output; and

- Develop formal procedures for performing and documenting compensating controls.

FINDING 2— Inappropriate keying access to the State’s payroll system

The Lottery lacked adequate controls to ensure that only appropriate staff had keying access to the State’s payroll system. If not mitigated, this control deficiency leaves payroll data at risk of misuse, abuse, and unauthorized use.

We audited the records of 11 Lottery employees who had keying access to the State’s payroll system at various times between July 2016 and April 2019. Of the 11 employees, five had inappropriate keying access to the State’s payroll system. The five individuals did not have their keying access immediately removed after their separation from state service, transfer to another agency, change in classification, or temporary access expired. For example, a Staff Services Manager I was allowed temporary keying access to the payroll system from August 25, 2016, through February 24, 2017. However, the Lottery did not remove or modify the employee’s access until April 24, 2019, 789 days later.

The SCO maintains the State’s payroll system. The system is decentralized, thereby allowing employees of state agencies to access it. PPSD has established a *Decentralized Security Program Manual* that all state agencies are required to follow in order to access the payroll system. The program’s objectives are to secure and protect the confidentiality and integrity of payroll data against misuse, abuse, and unauthorized use.

The *Decentralized Security Program Manual* states, in part:

The PPSD system contains sensitive and confidential information. Access is restricted to persons with an authorized, legal, and legitimate business requirement to complete their duties. . . .

Currently, PIMS, HIST, KEYM, PIP, LAS, MPC and/or ACAS applications are restricted to Personnel Specialists or Personnel Technician classifications because their need is by definition a function

of their specific job duties and any change in those duties requires a reevaluation of the need for access.

If the employee's duties change, such that the need for access no longer exists, the access privilege MUST be removed or deleted immediately by a request submitted by the department/campus. . . .

To prevent unauthorized use by a transferred, terminated or resigned employee's user ID, the Security Monitor must IMMEDIATELY submit all pages of the PSD125A to delete the user's system access. Using an old user ID increases the chances of a security breach which is a serious security violation. Sharing a user ID is strictly prohibited and a serious violation.

Recommendation

We recommend that the Lottery:

- Update keying access to the State's payroll system immediately after employees leave the Lottery, transfer to another unit, change classifications, or when temporary access period expires; and
- Periodically review access to the system to verify that access complies with the *Decentralized Security Program Manual*.

FINDING 3— Inadequate controls over vacation and annual leave balances, resulting in liability for excessive balances

The Lottery did not implement controls to ensure that it adhered to the requirements of collective bargaining agreements and state regulations to limit the accumulation of vacation and annual leave credits. This deficiency resulted in a known and likely liability for excessive leave balances with a value of at least \$903,755 as of March 31, 2019. We expect the liability to increase if the Lottery does not take action to address the excessive vacation and annual leave balances.

Collective bargaining agreements and state regulations limit the amount of vacation and annual leave that most state employees may accumulate to no more than 640 hours. The limit on leave balances helps state agencies to manage leave balances and control the State's liability for accrued leave credits. State agencies may allow employees to carry a higher leave balance only under limited circumstances. For example, an employee may not be able to reduce accrued vacation or annual leave hours below the limit due to business needs. When an employee's leave accumulation exceeds or is projected to exceed the limit, state agencies should work with the employee to develop a written plan to reduce leave balances below the applicable limit.

Our examination of the Lottery's leave accounting records determined that the Lottery had 774 employees with unused vacation or annual leave credits at March 31, 2019. Of those employees, 69 (9%) exceeded the limit set by collective bargaining agreements and state regulations. For example, one employee had an accumulated balance of 2,218 hours in annual leave, or 1,578 hours beyond the 640-hour limit. Collectively, the 69 employees accumulated more than 24,660 hours in excess vacation and annual leave, costing at least \$903,755 as of March 31, 2019.

We used a statistical sampling method to randomly select 31 of the 69 employees (as described in the Appendix) over the 640-hour limit to determine whether the Lottery complied with collective bargaining agreements and state regulations. The Lottery provided leave reduction plans for 25 of the 31 employees; however, the Lottery could not demonstrate that it had allowed the employees to carry vacation or annual leave balances beyond the limit based on exceptions specified in the bargaining agreements and state regulations.

The known liability for the 31 employees is approximately \$480,624. Because the statistical sample of 31 employees was representative of the population, we projected our finding upon the remaining population. This resulted in total known and likely liability due to noncompliance with bargaining agreements and state regulations to the state of approximately \$903,755. The following table summarizes the results of our statistical sampling:

Known excess vacation and annual leave balance liability	\$ 480,624
Divide by: Sample	480,624
Error rate for projection (differences due to rounding)	<u>100.00%</u>
Population that was statistically sampled	\$ 903,755
Multiply by: Error rate for projection	100.00%
Known and likely excess vacation and annual leave balance liability	<u>903,755</u>
Less: Known excess vacation and annual leave balance liability	480,624
Likely excess vacation and annual leave balance liability	<u>\$ 423,131</u>

* Amounts in this table are rounded to the nearest dollar.

This estimated liability does not adjust for salary rate increases and additional leave credits.² For example, a Lottery employee separated from state service with 1,687 hours in leave credits, including 1,597 hours in annual leave. After adjusting for additional leave credits, the employee was paid for 1,943 hours, or approximately 15% more. If the Lottery does not take action to reduce the excessive leave balances, the liability for accrued vacation and annual leave will likely increase. This is because most employees will receive salary increases or use other non-compensable leave credits instead of vacation or annual leave, increasing their vacation or annual leave balances.

Although an October 20, 2020 directive from CalHR does not affect the dollar value of this finding, we are disclosing this directive because it affects our recommendation. CalHR has directed departments to immediately suspend policies that require leave balances to be reduced below the limit, and that require employees to implement leave-reduction plans. This suspension will be in effect until the 2020 PLP ends, or July 1, 2022, whichever is sooner.

² Most state employees receive pay rate increases every year pursuant to state laws and/or collective bargaining agreements until they reach the top of their pay scale, or promote into a higher-paying position. In addition, when an employee's accumulated leave balances upon separation are calculated for lump-sum pay, the employee is credited with additional leave credits equal to the amount that the employee would have earned had the employee taken time off and not separated from state service.

Recommendation

We recommend that, after the 2020 PLP ends, or July 1, 2022, whichever is sooner, the Lottery:

- Implement controls to ensure that its employees' vacation and annual leave balances are maintained within levels allowed by collective bargaining agreements and state regulations;
- Conduct ongoing monitoring of controls to ensure that they are implemented and operating effectively; and
- Participate in leave buy-back programs if the State offers such programs and funds are available.

FINDING 4— Inadequate controls over separation lump- sum pay, resulting in improper and late payments

The Lottery lacked adequate controls over the processing of employee separation lump-sum pay. We identified a net total of \$691 of known and likely improper payments consisting of \$13,449 in known and likely overpayments and \$12,758 in known and likely underpayments. The Lottery also did not make separation lump-sum payments to 13 employees in a timely manner. If not mitigated, these control deficiencies leave the Lottery at risk of making additional improper and untimely separation lump-sum payments, noncompliance with agreements and laws, and liability for late payments.

GC section 19839 allows lump-sum payment for accrued eligible leave credits when an employee separates from state employment. Collective bargaining agreements include similar provisions regarding separation lump-sum pay.

The Lottery processed payments for separation lump-sum pay, totaling \$1,532,296, for 133 employees between July 2016 and April 2019. We examined the separation lump-sum pay for the 12 employees with the highest payments, totaling \$548,771. Of the 12 employees, the Lottery overpaid three of them by \$2,386, and underpaid three of them by approximately \$2,561 because Transactions and Payroll Unit staff miscalculated the number of hours that would be paid in the lump sum payment.

Of the remaining 121 payments to employees, totaling \$983,525, we randomly selected a statistical sample (as described in the Appendix) of 54 employees who were paid separation lump-sum pay, totaling \$399,523. We found that the Lottery overpaid six of them by approximately \$4,494 and underpaid seven of them by approximately \$4,142. The overpayments and underpayments were made because Transactions and Payroll Unit staff miscalculated leave balances paid. The Lottery also lacked adequate supervisory review to ensure accurate processing of separation lump-sum pay.

As we used a statistical sampling method to select the employees whose payments for separation lump-sum pay were examined, we projected the amount of likely overpayments to be \$6,569 and likely underpayments to be \$6,055.

The following table summarizes the results of our statistical sampling:

Known improper payments, net	\$ 352
Divide by: Sample	399,523
Error rate for projection (differences due to rounding)	<u>0.09%</u>
Population that was statistically sampled	983,525
Multiply by: Error rate for projection	<u>0.09%</u>
Known and likely improper payments, net (differences due to rounding)	866
Less: Known improper payments, net	352
Likely improper payments, net	<u>\$ 514</u>

* Amounts in this table are rounded to the nearest dollar.

In addition, of the 66 separation lump-sum payments that we examined, 13 were not paid in a timely manner, in violation of collective bargaining agreements and state laws, as summarized in the *CalHR Human Resources Manual*, section 1703.

GC sections 13400 through 13407 require state agencies to establish and maintain internal controls, including an effective system of internal review.

Recommendation

We recommend that the Lottery:

- Establish adequate controls to ensure accurate calculation and timely payment of separation lump-sum pay;
- Conduct a review of payments for separation lump-sum pay made during the past three years to ensure that the payments were accurate and in compliance with collective bargaining agreements and state law; and
- Recover overpayments made to separated employees in accordance with GC section 19838 and *State Administrative Manual (SAM)* section 8776.6, and properly compensate those employees who were underpaid.

**FINDING 5—
Inadequate
controls over
overtime pay,
resulting in
improper and
questioned
payments**

The Lottery lacked adequate controls over the processing of overtime pay. We identified a net total of \$33,395 of known and likely improper and questioned overtime payments. This consists of \$24,071 in known and likely overpayments, \$4,380 known and likely underpayments, and \$13,704 in known and likely questioned payments. If not mitigated, the control deficiencies leave the Lottery at risk of making additional improper payments for overtime pay.

The Lottery processed 1,639 overtime pay transactions, totaling \$1,072,513, between July 2016 and April 2019. We examined all four overtime pay transactions, totaling \$1,764, for Work Week Group (WWG) E employees who are not eligible to receive overtime pay under

normal circumstances. Of the four transactions, the Lottery overpaid two payments to one employee, totaling \$85. The employee was not eligible for overtime compensation.

CalHR's *California State Civil Service Pay Scales*, section 10, states, in part:

Work Week Group "E" includes classes that are exempted from coverage under the Fair Labor Standards Act because of the "white-collar" (administrative, executive, professional) exemptions. To be eligible for this exemption a position must meet both the "salary basis" and the "duties" test.

Exempt (WWG E) employees are paid on a "salaried" basis and the regular rate of pay is full compensation for all hours worked to perform assigned duties. However, these employees shall receive up to 8 hours holiday credit when authorized to work on a holiday. WWG E employees shall not receive any form of additional compensation, whether formal or informal, unless otherwise provided by the provisions of this work week group.

We also examined 20 overtime pay transactions, totaling \$188,828, for WWG 2 employees who were paid for at least 60 hours. We found that of the 20, two were overpayments, totaling \$293.

Of the remaining 1,615 overtime pay transactions, totaling \$881,921, for WWG 2 employees who were paid for less than 60 hours of overtime between July 2016 and April 2019, we randomly selected a statistical sample (as described in the Appendix) of 105 transactions, totaling \$61,009. Of the 105 transactions, the Lottery overpaid 20 of them by \$1,639, and underpaid one by \$303. We also questioned two transactions, totaling \$948, because the Lottery could not provide timesheets to support that the payments were valid and authorized.

As we used a statistical sampling method to select the overtime pay transactions examined, we projected the amount of likely overpayments to be \$22,054, likely underpayments to be \$4,077, and likely questioned payments to be \$12,756.

The following table summarizes the results of our statistical sampling:

Known improper and questioned payments, net	\$ 2,284
Divide by: Sample	<u>61,009</u>
Error rate for projection (difference due to rounding)	<u>3.7437%</u>
Population that was statistically sampled	881,921
Multiply by: Error rate for projection	<u>3.74371%</u>
Known and likely improper and questioned payments, net (difference due to rounding)	33,017
Less: Known improper and questioned payments, net	<u>2,284</u>
Likely improper and questioned payments, net	<u>\$ 30,733</u>

* Amounts in this table are rounded to the nearest dollar.

The known overpayments and underpayment occurred because Transactions and Payroll Unit staff made keying and calculation errors. The Lottery also lacked adequate supervisory review to ensure accurate processing of overtime pay.

GC sections 13402 through 13407 require state agencies to establish and maintain internal controls, including a system of policies and procedures adequate to ensure compliance with applicable laws and other requirements, and an effective system of internal review.

Recommendation

We recommend that the Lottery:

- Conduct a review of payments for overtime pay made during the past three years to ensure that the payments complied with collective bargaining agreements and state laws and policies; and
- Recover overpayments made to employees through an agreed-upon collection method in accordance with GC section 19838, and properly compensate those employees who were underpaid.

We further recommend that, to prevent improper overtime payments from recurring, the Lottery:

- Establish adequate internal controls to ensure that payments are accurate and comply with collective bargaining agreements and state laws and policies; and
- Provide adequate oversight to ensure that the Transactions and Payroll Unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies.

FINDING 6— Inadequate controls over bonus payments, resulting in improper payments

The Lottery lacked adequate controls over the processing of payment type 9G bonus pay. We identified \$80,222 in known and likely overpayments for bonus pay. If not mitigated, the control deficiencies leave the Lottery at risk of additional improper payments for bonus pay.

The Lottery processed 3,615 bonus pay transactions, totaling \$6,886,700, between July 2016 and April 2019.

We examined six employees' bonus pay transactions, totaling \$25,000, because they did not appear to adhere to the SEIU Local 1000 \$2,500 signing bonus criteria. The Lottery overpaid five of the six employees, totaling \$12,500. Four employees were paid \$2,500 twice, and one employee was not eligible for the bonus.

Section 11.2 A., Signing Bonus, of the collective bargaining agreements between the State and Bargaining Units 1, 3, 4, 11, 14, 15, 17, 20, and 21, effective for the period of July 2, 2016, through January 1, 2020, states:

Upon ratification of the MOU, SEIU Local 1000 represented employees shall receive a one-time bonus of two thousand five hundred dollars (\$2,500)...

We also examined the four highest bonus pay transactions (excluding the SEIU \$2,500 bonus transactions), totaling \$16,530. Our examination of the transactions found no exceptions. Of the remaining 3,078 9G bonus pay transactions, totaling \$5,530,170, we randomly selected a statistical sample (as described in the Appendix) of 105 transactions, totaling \$188,635. Of the 105 transactions, the Lottery overpaid four of them, totaling \$2,310. As we used a statistical sampling method to select the bonus pay transactions examined, we projected the amount of likely overpayments to be \$65,412. The overpayments occurred because Transactions and Payroll Unit staff made keying errors, and because sales bonus reports did not match system information. The Lottery also lacked adequate supervisory review to ensure accurate processing of bonus pay.

The following table summarizes the results of our statistical sampling:

Known improper payments, net	\$ 2,310
Divide by: Sample	<u>188,635</u>
Error rate for projection (difference due to rounding)	<u>1.2246%</u>
Population that was statistically sampled	5,530,170
Multiply by: Error rate for projection	<u>1.22459%</u>
Known and likely improper payments, net (difference due to rounding)	67,722
Less: Known improper payments, net	<u>2,310</u>
Likely improper payments, net	<u>\$ 65,412</u>

* Amounts in this table are rounded to the nearest dollar.

GC sections 13402 through 13407 require state agencies to establish and maintain internal controls, including a system of policies and procedures adequate to ensure compliance with applicable laws and other requirements, and an effective system of internal review.

Recommendation

We recommend that the Lottery:

- Conduct a review of bonus payments made during the past three years to ensure that the payments complied with collective bargaining agreements and state laws and policies; and
- Recover overpayments made to employees through an agreed-upon collection method in accordance with GC section 19838.

We further recommend that, to prevent improper bonus payments from recurring, the Lottery:

- Establish adequate internal controls to ensure that payments are accurate and comply with collective bargaining agreements and state laws and policies; and
- Provide adequate oversight to ensure that Transactions and Payroll Unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies.

**FINDING 7—
Inadequate
controls over
holiday credit
transactions,
resulting in
improper credits**

The Lottery lacked adequate controls over the processing of holiday credit transactions. We identified approximately \$12,331 in improper holiday credits. In addition, we questioned one transaction, valued at \$838, because the timesheet could not be provided. If not mitigated, this control deficiency leaves the Lottery at risk of granting additional improper holiday credits.

The Lottery processed 1,216 accrual transactions of holiday credit between July 2016 and April 2019. We examined 34 of these transactions, with an estimated value of \$16,704, because they contained irregular credit amounts. Of the 34 transactions, 30 were improper credits, with an estimated value of \$12,331. In addition, the Lottery could not provide supporting documentation for one transaction; therefore we questioned an accrual of 24 hours with an estimated value of \$838.

The improper holiday credit transactions were made because Transactions and Payroll Unit staff improperly calculated holiday credit hours. The Lottery also lacked adequate supervisory review to ensure accurate processing of holiday credits.

GC section 19853 specifies the compensation that an eligible employee is entitled to receive when required to work on a qualifying holiday. Collective bargaining agreements between the State and Bargaining Units 1 and 7 include similar provisions regarding holiday compensation for represented employees.

GC sections 13400 through 13407 require state agencies to establish and maintain internal controls, including an effective system of internal review.

Recommendation

We recommend that the Lottery:

- Conduct a review of holiday credits granted during the past three years to ensure that credits complied with collective bargaining agreements and state law;
- Correct any improper holiday credits in the State's leave accounting system; and
- Establish adequate controls to ensure that holiday credits granted are valid and comply with collective bargaining agreements and state law.

**FINDING 8—
Inadequate
controls over
salary advances,
resulting in
outstanding
amounts**

The Lottery lacked adequate controls over salary advances to ensure that they were recovered in accordance with state law and policies. We determined that three salary advances, totaling \$2,500, were not properly collected and remained outstanding as of April 30, 2019. The oldest unrecovered salary advance was outstanding for over two years. If not mitigated, this control deficiency leaves the Lottery at risk of failing to collect further salary advances.

At April 30, 2019, the Lottery's accounting records showed eight outstanding salary advances, totaling \$10,935, including two balances totaling \$2,300 that had been outstanding for more than one year. Generally, the prospect of collection diminishes as an account ages. When an agency is unable to collect after three years, the possibility of collection is remote.

The Lottery also did not adequately retain supporting documentation for salary advances. In addition to the two salary advances noted above, the Lottery could not provide adequate supporting documentation for another salary advance, totaling \$200. Only the Salary Advance Request form could be provided. The Lottery did not have documentation to show collection efforts or calculation of salary advance amounts.

The lack of adequate controls over salary advances reduces the likelihood of collection, increases the amount of resources expended on collection efforts, and negatively impacts cash flow.

GC section 19838 and SAM sections 8776 and 8776.7 describe the State's collection policies and procedures, which require the Lottery to collect salary advances in a timely manner and maintain proper records of collection efforts and payments.

Recommendation

We recommend that the Lottery:

- Ensure that it recovers salary advances in a timely manner pursuant to GC section 19838 and SAM sections 8776 and 8776.7; and
- Maintain documentation of its collection efforts and payment of salary advances.

Appendix— Statistical Sampling Methodology

Audit Area	Type of Test ^a	Population (Unit)	Population (Dollar)	Sampling Unit	Sample Selection Method	Confidence Level	Tolerable Error Rate	Expected Error (Rate) ^b	Sample Size	Results Projected to Intended Population	Finding Number
Regular Pay	Compliance	25,977	\$ 131,774,771	Transaction	Computer-generated simple random	90%	5%	0 (0.0%)	45	Yes	N/A
Excess vacation and annual leave balances	Compliance	69	903,755	Employee	Computer-generated simple random	90%	10%	2 (1.0%)	31	Yes	3
Separation lump-sum pay	Compliance	121	983,525	Employee	Computer-generated simple random	90%	5%	2 (1.0%)	54	Yes	4
Overtime pay	Compliance	1,615	881,921	Transaction	Computer-generated simple random	90%	5%	2 (1.5%)	105	Yes	5
Bonus pay	Compliance	3,078	5,530,170	Transaction	Computer-generated simple random	90%	5%	2 (1.5%)	105	Yes	6

^a We used attribute sampling for tests of compliance. It allowed us to achieve our objectives in an efficient and effective manner. The sample was designed in accordance with the American Institute of Certified Public Accountants guidelines.

^b Pursuant to the American Institute of Certified Public Accountant's *Audit Guide: Audit Sampling* (May 1, 2017 edition), pages 131-133, the expected error is the expected number of errors planned for in the sample. It is derived by multiplying the expected error rate by the sample size. The expected number of errors in the sampling tables on pages 135-136 was rounded upward, e.g., 0.2 errors becomes 1.0 error.

**Attachment—
California State Lottery’s
Response to Draft Report**



November 16, 2020

Andrew Finlayson,
State Agency Audits Bureau Chief
State Controller's Office
Division of Audits, Post Office Box 942850, Sacramento, CA 94250.

Re: Response to SCO Draft Payroll Process and Transactions Report

Dear Mr. Finlayson:

Thank you for allowing the California State Lottery (Lottery) the opportunity to review and respond to the State Controller's Office (SCO) Draft Payroll Process and Transactions (Report) that covers the period July 1, 2016 through April 30, 2019. In general, we find the Report to be a fair and accurate representation of the processes that existed during the time period reviewed. We also reviewed the recommendations on improving internal controls to address deficiencies noted in the Report and find them to be helpful and constructive.

We are pleased to note that prior to receiving this Report, we had already begun to implement additional internal control measures that we believe will address the deficiencies identified in the Report. Further, the Lottery's Human Resources Division (HRD) is working towards establishing and maintaining an internal compliance review unit for its payroll processes. This will include a Human Resource Compliance Analyst internally reviewing employment history transactions entered into the SCO payroll system and payroll transactions issued. Any discrepancies discovered by the Compliance Analyst will be addressed immediately. Follow-up training will be provided as necessary to individual staff and Transaction & Payroll Unit staff, based on the discrepancies found, to prevent similar occurrences in the future.

The Lottery takes its mission seriously and understands the importance of performing duties in a cost-effective and transparent manner to ensure public resources are safeguarded. As stated above, the Report focused on the payroll process and we are pleased to note that after a thorough review there are no findings that would hinder the Lottery's performance of its mission which is to provide supplemental funding for public education in California.

The Lottery is continuing to review each recommendation in the Report against current processes to ensure they adequately address the challenges noted. If internal reviews indicate that current processes are insufficient to address noted deficiencies, the Lottery will take appropriate corrective actions to improve internal controls.

The following addresses each finding in the Report specifically.

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Finding 1 – Inadequate segregation of duties and lack of compensating controls over the processing payroll transactions

RECOMMENDATION:

The Lottery should separate conflicting payroll function duties to the greatest extent possible. Adequate segregation of duties will provide a stronger system of internal control whereby the functions of each employee are subject to the review of another.

If it is not possible to segregate payroll functions fully and appropriately, the Lottery should implement compensating controls. For example, if the Transactions and Payroll Unit staff member responsible for recordkeeping also performs a reconciliation process, then the supervisor should perform and document a detailed review of the reconciliation to provide additional control over the assignment of conflicting functions. Compensating controls may also include dual authorization requirements and documented reviews of payroll system input and output; and develop formal procedures for performing and documenting compensating controls.

RESPONSE:

The Lottery agrees. HRD currently has four Personnel Specialists and one Senior Personnel Specialist responsible for processing payroll transactions; therefore, based on HRD staffing, separating the functions would not be beneficial especially when covering for absences or vacancies. With that in mind, the Lottery has begun implementing compensating controls. HRD currently has one Compliance Analyst whose duties include post reviewing payroll transactions. Specific post review tasks related to this finding are being developed to ensure effective routine post reviews are completed. To ensure compliance, the Lottery is in the process of requesting additional HRD positions to provide compliance reviews internally. Specific internal compliance reviews will be developed, documented, and performed routinely. Compliance review findings will be documented, and training will be provided in areas with specific findings.

Finding 2 – Inappropriate keying access to the State's payroll system

RECOMMENDATION:

The Lottery should update keying access to the State's payroll system immediately after employees leave the Lottery, transfer to another unit, change classifications, or when temporary access period expires; and periodically review access to the system to verify that access complies with the Decentralized Security Program Manual.

RESPONSE:

The Lottery agrees and has already implemented periodic reviews of SCO payroll system access with two security monitors within HRD. On a monthly basis, two security monitors meet to review SCO payroll system access with specific employee names and system access. They then review current HRD movement reports to check if any HRD staff had a change in assignment which would then trigger a review of payroll system accesses. HRD will appropriately update access privileges immediately upon the time an employee

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changes status. If not immediately, access privileges will be updated within the same month.

Finding 3 – Inadequate controls over vacation and annual leave balances, costing the State liability for excessive credits

RECOMMENDATION:

The Lottery should implement controls to ensure that its employees' vacation and annual leave balances are maintained within levels allowed by collective bargaining agreements and state regulations; conduct ongoing monitoring of controls to ensure that they are implemented and operating effectively; and participate in leave buy-back programs if the State offers such programs and funds are available.

RESPONSE:

The Lottery agrees that it is critical to uphold the collective bargaining agreements and state regulations regarding maximum vacation and annual leave balances to decrease the State's liability. Accordingly, the Lottery will continue to ensure employees with leave balances in excess of 640 hours submit a leave reduction plan annually. The Lottery will participate in leave cash-out and buy back programs when programs are available, and funding is possible.

Prior to this audit, the Lottery had a draft Leave Management Policy under review. This draft policy specifically addressed Lottery's leave reduction process. The Lottery will amend that draft policy to include requirements for justification along with the employees leave reduction plans to ensure the employee does or does not meet the provisions of the collective bargaining agreements. As discussed with SCO personnel, such justifications would include; (1) was required to work as a result of fire, flood, or other extensive emergency; (2) was assigned work of a priority or critical nature over an extended period of time; (3) was absent on full salary for compensable injury; (4) was prevented by department regulations from taking Vacation/Annual Leave until December 31 because of sick leave; or (5) was on jury duty, and require management review and approval.

Finding 4 – Inadequate controls over separation lump-sum pay, resulting in improper and late payments

RECOMMENDATION:

The Lottery should establish adequate controls to ensure accurate calculation and timely payment of separation lump-sum pay; conduct a review of payments for separation lump-sum pay made during the past three years to ensure that the payments were accurate and in compliance with collective bargaining agreements and state law; and recover overpayments made to separated employees in accordance with GC section 19838 and State Administrative Manual (SAM) section 8776.6, and properly compensate those employees who were underpaid.

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RESPONSE:

The Lottery agrees. Reviews of separation lump-sum payments for the past three years have been completed and corrected in accordance with Government Code 19838 and the State Administrative Manual section 8776.6. Approximately six months ago, HRD implemented a Separation Checklist which payroll staff are required to utilize for separations. Once staff completes all applicable responsibilities on the checklist, they sign off and provide it to the next level of review, the Transaction Manager. The Transaction Manager then reviews the checklist, tasks completed, and lump sum calculations to ensure accuracy. If accurate, the Transaction Manager signs off and the payroll staff key the transaction. Any discrepancies found by the Transactions Manager are corrected by payroll staff and then entered into the payroll system accurately. HRD will also implement a post-keying audit process and have the Compliance Analyst review the lump sum issued in the payroll system in comparison to the documented separation checklist. The Compliance Analyst will also sign off that the compliance audit has been completed and retain documentation.

Payroll staff completed beginning training on timely payment of wages rules and laws. HRD will ensure that payroll and compliance analyst staff receive The Hours of Work formal training by year end.

Finding 5 – Inadequate controls over overtime pay, resulting in improper and questioned payments

RECOMMENDATION:

The Lottery should conduct a review of payments for overtime pay made during the past three years to ensure that the payments complied with collective bargaining agreements and state laws and policies; and recover overpayments made to employees through an agreed-upon collection method in accordance with GC section 19838, and properly compensate those employees who were underpaid. Also, recommended further, to prevent improper overtime payments from recurring, the Lottery will establish adequate internal controls to ensure that payments are accurate and comply with collective bargaining agreements and state laws and policies; and provide adequate oversight to ensure that the Transactions and Payroll Unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies.

RESPONSE:

The Lottery agrees. A review of overtime payments made within the past three years has been completed. Necessary corrections have been made to bring the Lottery into compliance with the collective bargaining agreements, state laws and rules. Payroll staff completed basic training on overtime eligibility and payments to ensure a basic understanding of the collective bargaining agreements, state laws and rules. HRD will ensure that payroll and compliance staff receive The Hours of Work formal training by year end. HRD will make it a priority to ensure that payroll and compliance staff know the laws and rules regarding overtime and the correct compensation rules and eligibility for overtime. HRD will provide the necessary tools and resources to staff. The Compliance Analyst will perform a monthly review of overtime issued, document the review's

Andy Finlayson
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completion, and escalate errors immediately to HRD management for correction and training.

Finding 6 – Inadequate controls over 9G bonus payments, resulting in improper payments

RECOMMENDATION:

The Lottery should conduct a review of bonus payments made during the past three years to ensure that the payments complied with collective bargaining agreements and state laws and policies; and recover overpayments made to employees through an agreed-upon collection method in accordance with GC section 19838. Further, it is recommend that, to prevent improper bonus payments from recurring, the Lottery will establish adequate internal controls to ensure that payments are accurate and comply with collective bargaining agreements and state laws and policies; and provide adequate oversight to ensure that Transactions and Payroll Unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies.

RESPONSE:

The Lottery agrees. A review of bonus payments for the past three years is currently being completed. Errors will be corrected in accordance with Government Code Section 19838. Moving forward, a new process has been implemented that requires the assignment of specific bonus processing to a specific payroll staff. Previously, assignments on bonus pay were unclear leading to the potential that duplicate bonuses may be issued and released. After processing a bonus, a post keying audit will be completed by the payroll staff keying and certifying a bonus. After bonuses have been processed through the payroll system a post keying compliance audit will be completed by the Compliance Analyst to ensure they are accurate; this process will be in effect by the next issuance of bonuses in December 2020.

Finding 7 – Inadequate controls over holiday credits, resulting in improper and questioned credits

RECOMMENDATION:

The Lottery should conduct a review of holiday credits granted during the past three years to ensure that credits complied with collective bargaining agreements and state law; correct any improper holiday credits in the State's leave accounting system; and establish adequate controls to ensure that holiday credits granted are valid and comply with collective bargaining agreements and state laws.

RESPONSE:

The Lottery agrees. Review of Holiday Credits granted for the past three years has been completed, and corrections have been made in accordance with collective bargaining agreements and state laws and policies. Payroll staff will be trained on the provisions of holiday credits within the laws, rules and collective bargaining agreements. A process will be established and followed with the Compliance Analyst completing a post-keying

Andy Finlayson
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compliance audit of holiday credit accruals. Any associated findings will be documented, corrected and staff will be re-trained as needed.

Finding 8 – Inadequate controls over salary advances, resulting in outstanding amounts

RECOMMENDATION:

The Lottery should ensure that it recovers salary advances in a timely manner pursuant to GC section 19838 and SAM sections 8776 and 8776.7; and maintain documentation of its collection efforts and payment of salary advances.

RESPONSE:

The Lottery agrees. In September 2020, HRD along with the Lottery's Division of Finance, Accounting Operations developed and implemented a monthly salary advance report. This report is released to management and payroll staff prior to SCO monthly dock cutoff to ensure that outstanding salary advances are addressed timely and cleared prior to pay-day. In addition, payroll staff have been instructed to document the justification on the salary advance request, retain the request according to current retention schedules, and clear salary advances timely. The expectation has been set that salary advances will not remain unpaid for over 30 days.

CONCLUSION:

The Lottery is committed to processing payroll and leave transactions accurately and in accordance with laws, regulations, and applicable collective bargaining agreements. The goal of Lottery is to have no deficiencies in its payroll processes and ensure Lottery staff are paid exactly what they are due. The Lottery will continue to train staff and modify processes to achieve the goal of 100 percent compliance. The Lottery is looking forward to developing its new compliance unit to help meet this goal.

As recommended, all findings noted in this Report and noncompliant transactions over the last three years will be addressed accordingly by the Lottery. For those areas resulting in overpayments, collections have been started consistent with Government Code 19838. Instances in which staff were underpaid have been addressed accordingly and the California Leave Accounting System has been updated appropriately for existing employees.

Thank you again for the opportunity to review and respond to the Report. If you have any additional questions, please contact Deputy Director of Internal Audits, Roberto Zavala at (916) 822-8358.

Sincerely,

DocuSigned by:

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Alva V. Johnson
Director

**State Controller's Office
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