CALIFORNIA DEPARTMENT OF WATER RESOURCES

Audit Report

PAYROLL AUDIT

August 1, 2015, through July 31, 2018

BETTY T. YEE

California State Controller

July 2019

BETTY T. YEE
California State Controller

July 15, 2019

Karla Nemeth, Director
California Department of Water Resources
P.O. Box 942836
Sacramento, CA 94236

Dear Ms. Nemeth:

The State Controller's Office audited the California Department of Water Resources's (DWR) payroll process and transactions for the period of August 1, 2015, through July 31, 2018.

Our audit found material weaknesses in internal control over the DWR payroll process. These weaknesses contributed to DWR employees' excessive vacation and annual leave balances, improper and questioned payments, and improperly issued and long-outstanding salary advances, costing the State an estimated net total of $8,557,291.

If you have any questions, please contact Andrew Finlayson, Chief, State Agency Audits Bureau, by telephone at (916) 324-6310.

Sincerely,

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

JLS/ls

cc: Katherine S. Kishaba, Deputy Director
Business Operations
California Department of Water Resources
Jennifer Dong Kawate, Chief
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Audit Report

Summary

The State Controller's Office (SCO) audited the California Department of Water Resources's (DWR) payroll process and transactions for the period of August 1, 2015, through July 31, 2018. DWR management is responsible for maintaining a system of internal control over the payroll process within its organization, and for ensuring compliance with various requirements under state laws and regulations regarding payroll and payroll-related expenditures. We completed our audit fieldwork on May 23, 2019.

Our audit determined that DWR:

- 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:
  - o Lack of adequate segregation of duties and compensating controls over the processing of payroll transactions (see Finding 1);
  - o Inappropriate keying access to the State's payroll system (see Finding 2);
  - o Lack of sufficient controls over the processing of specific payroll-related transactions to ensure that DWR complied with collective bargaining agreements and state laws, and that only valid and authorized payments were processed (see Findings 3, 4, 5, and 6);
- 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 with the requirements of collective bargaining agreements and state laws, regulations, policies, and procedures:
  - o Failure to adhere to the requirements of collective bargaining agreements and state regulations to limit the accumulation of vacation and annual leave credits, resulting in liability for excessive leave balances with a value of at least $8,137,889 as of July 31, 2018 (see Finding 3);
  - o Improper payments made for overtime pay, leave buy-back, and separation lump-sum pay, costing a net total of $408,903 (see Findings 4, 5, and 6); and
- Did not administer salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures (see Finding 7).

Background

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. Periodic audits of the decentralized payroll processing at state agencies and departments ceased due to the budget constraints in the late 1980s.

In 2013, the California State Legislature reinstated these payroll audits to gain assurance that state agencies and departments maintain adequate internal control over the payroll function, provide proper oversight of their decentralized payroll processing, and comply with various state laws and regulations regarding payroll processing and related transactions.

Audit Authority

Authority for this audit is provided by California Government Code (GC) section 12476, which 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 pay roll system, in such manner as the Controller may determine." In addition, GC section 12410 stipulates that "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 provisions of law for payment."

Objectives, Scope, and Methodology

We performed this audit to determine whether DWR:

- 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 covered the period from August 1, 2015, through July 31, 2018.

To achieve our audit objectives, we:

- Reviewed state and DWR policies and procedures related to the payroll process to understand DWR's methodology for processing various payroll and payroll-related transactions;
- Interviewed DWR payroll personnel to understand DWR's methodology for processing various payroll and payroll-related transactions, determine their level of knowledge and ability relating to payroll transaction processing, and gain an understanding of existing internal control over the payroll process and systems;
- Selected transactions recorded in the State's payroll database using statistical sampling, as outlined in the Appendix, and targeted selection based on risk factors and other relevant criteria;
- 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 salary advances to determine whether DWR 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.

Conclusion

Our audit determined that DWR:

- Did not maintain adequate and effective internal controls over its payroll process[1]. We found the following deficiencies in internal control over the payroll process that we consider to be material weaknesses:
    - Lack of adequate segregation of duties and compensating controls over the processing of payroll transactions (see Finding 1);
    - Inappropriate keying access to the State's payroll system (see Finding 2);
    - Lack of sufficient controls over the processing of specific payroll-related transactions to ensure that DWR complied with collective bargaining agreements and state laws, and that only valid and authorized payments were processed (see Findings 3, 4, 5, and 6);
- 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 with the requirements of collective bargaining agreements and state laws, regulations, policies, and procedures:
    - Failure to adhere to the requirements of collective bargaining agreements and state regulations to limit the accumulation of vacation and annual leave credits, resulting in liability for excessive leave balances with a value of at least $8,137,889 as of July 31, 2018 (see Finding 3);

[1]In planning and performing our audit of compliance, we considered DWR's internal control over compliance with collective bargaining agreements and state laws, regulations, policies, and procedures to determine the auditing procedures that were appropriate under the circumstances for the purpose of providing a conclusion on compliance, and to test and report on internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this footnote and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. However, as discussed this section, we identified certain deficiencies in internal control over compliance that we consider to be material weaknesses.

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 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.

  - Improper payments made for overtime pay, leave buy-back, and employee separation lump-sum pay, costing a net total of $408,903 (see Findings 4, 5, and 6); and

- Did not administer salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures (see Finding 7).

Follow-up on Prior Audit Finding

The California State Auditor issued an *Investigations of Improper Activities by State Agencies and Employees* report regarding investigated allegations of improper governmental activities that were between January 2017 and June 2017. The report included a finding and recommendations that were relevant to our audit objectives. Based on the work performed in the current audit, we noted that DWR has taken appropriate corrective actions in response to the California State Auditor's finding.

Views of Responsible Officials

We issued a draft audit report on June 18, 2019. Katherine S. Kishaba, Deputy Director, Business Operations, responded by letter dated June 28, 2019 (Attachment), agreeing with the findings and indicating that DWR will take steps to correct the deficiencies noted. We will follow up during the next payroll audit to verify that the corrective actions are adequate and appropriate.

Restricted Use

This audit report is solely for the information and use of DWR 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 audit report, which is a matter of public record and is available on the SCO website at www.sco.ca.gov.

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

July 15, 2019

Schedule— Summary of Findings August 1, 2015, through July 31, 2018

Finding Number	Issues	Number of Selections Audited	Method of Selection	Selection Unit	Dollar Amount of Selections Audited	Number of Selections with Issues	Issues as a Percentage of Selections Audited *	Dollar Amount of Known Issues	Dollar Amount of Likely Issues	Total Dollar Amount of Known and Likely Issues
1	Inadequate segregation of duties and compensating controls over payroll transactions	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
2	Inappropriate keying access to the State's payroll system	41	Targeted	Employee	$ -	16	39%	$ -	N/A	$ -
3	Inadequate controls over vacation and annual leave balances, resulting in liability for excessive balances	45	Statistical	Employee	650,502	45	100%	650,502	$ 7,487,387	8,137,889
4	Inadequate controls over overtime pay, resulting in improper and questioned payments									
	Overpayments	105	Statistical	Payment transaction	162,116	3	3%	376	126,303	126,679
	Underpayments	10	Random selection	Payment transaction	8,887	1	10%	(48)	N/A	(48)
	Overpayments	64	Targeted	Payment transaction	125,820	12	19%	6,944	N/A	6,944
	Questioned payment	11	Targeted	Payment transaction	180,936	1	2%	669	N/A	669
5	Inadequate controls over leave buy-back, resulting in improper and questioned payments									
	Overpayments	105	Statistical	Payment transaction	397,819	2	2%	450	5,597	6,047
	Underpayments		--Same selections above--			4	4%	(425)	(5,283)	(5,708)
	Questioned payments		--Same selections above--			7	7%	23,391	290,552	313,943
6	Inadequate controls over separation lump-sum pay, resulting in improper payments									
	Overpayments	105	Statistical	Employee	2,741,744	10	10%	10,982	46,082	57,064
	Underpayments		--Same selections above--			17	16%	(18,256)	(76,601)	(94,857)
	Overpayments	14	Targeted	Employee	2,532,258	1	7%	35	N/A	35
	Underpayments		--Same selections above--			3	21%	(1,865)	N/A	(1,865)
7	Inadequate controls over salary advances, resulting in failure to properly issue and recover outstanding amounts	4	Targeted	Salary advance transaction	10,499	4	100%	10,499	N/A	10,499
	Total				$ 6,810,581			$ 683,254	$ 7,874,037	$ 8,557,291

*All percentages are rounded to the nearest full percentage point.

Findings and Recommendations

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

DWR lacked adequate segregation of duties within its payroll transactions unit to ensure that only valid and authorized payroll transactions were processed. DWR 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 DWR payroll transactions 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. DWR failed to demonstrate that it had implemented compensating controls to mitigate the risks associated with such a deficiency. We found no indication that these functions were subjected to periodic supervisory review.

The lack of adequate segregation of duties and compensating controls has a pervasive effect on the DWR 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 7, represent a material weakness in internal control over the payroll process 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.

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 DWR:

- 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, DWR should implement compensating controls. For example, if the payroll transactions 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

DWR lacked adequate controls to ensure that only appropriate staff had keying access to the State's payroll system. DWR inappropriately allowed 16 employees 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.

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.

We examined the records of 41 DWR employees who had keying access to the State's payroll system at various times between August 2015 and July 2018. Of the 41 employees, 16 had inappropriate keying access to the State's payroll system. Specifically, DWR did not immediately remove or modify keying access for 14 employees after the employees' separation from state service, transfer to another agency, or change in classification. For example, a Personnel Specialist separated from state service on August 7, 2017; DWR did not request to remove the employee's keying access until November 21, 2017, 106 days later. In addition, two of the 16 employees had keying access to the system while appointed to Associate Government Program Analyst and Associate Personnel Analyst classifications, which are ineligible to have keying access to the payroll system without the required justification; DWR did not provide the justification letter for these employees.

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. . . .
>
> A request to grant access to an individual in a classification other than in the Personnel Specialist/Payroll Technician series to access PIMS, HIST, KEYM, PIP, LAS, MPC and/or ACAS requires a written justification from the Authorizing Manager. The justification must describe the individual's specific job duties requiring the need to access system information (i.e., PIMS = Employment History, HIST=Payroll History, LAS=Leave Accounting System, etc.) as well as level of access to that application, in order to perform their regular daily duties. . . .
>
> 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 DWR:

- Update keying access to the State's payroll system immediately after employees leave DWR, transfer to another unit, or change classifications; 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

DWR failed to implement controls to ensure that it adheres to the requirements of collective bargaining agreements and state regulations to limit the accumulation of vacation and annual leave credits. These deficiencies resulted in liability for excessive leave balances with a value of at least $8,137,889 as of July 31, 2018. We expect the liability to increase if the DWR 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 80 days (640 hours). The limit on leave balances helps state agencies 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 for reducing leave balances below the applicable limit.

Our examination of DWR's leave accounting records determined that DWR had 3,189 employees with unused vacation or annual leave credits at July 31, 2018. Of those employees, 472 exceeded the limit set by collective bargaining agreements and state regulations. For example, one employee had an accumulated balance of 3,130 hours in annual leave, or 2,490 hours beyond the 640-hour limit. Collectively, the 472 employees accumulated 141,143 hours in excess vacation and annual leave, with a value of at least $8,137,889 as of July 31, 2018. This estimated liability does not adjust for salary rate increases and additional leave credits. [2] Accordingly, we expect that the amount needed to pay for the liability will be higher. For example, a DWR employee separated from state service with 2,099 hours in leave credits, including 1,931 hours in annual leave. After adjusting for additional leave credits, the employee was paid for 2,499 hours, or approximately 19% more.

Of the 472 employees who exceeded the limit on vacation and annual leave balances, we randomly selected a statistical sample (as described in the Appendix) of 45 employees, with excess vacation and leave balances valued at $650,502, for further examination of DWR's compliance with collective bargaining agreements and state regulations. DWR could not demonstrate that it had complied with collective bargaining agreements and state regulations when allowing these employees to maintain excess vacation or annual leave balances. In addition, 18 of the 45 employees did not have plans in place during the audit period to reduce leave balances below the limit.

As we used a statistical sampling method to select the employees with excess vacation and annual leave that we examined, we projected the value of likely excess vacation and annual leave balances that did not comply with collective bargaining agreements and state regulations to be $7,487,387. Therefore, the known and likely value of likely excess vacation and annual leave balances that did not comply with collective bargaining agreements and state regulations totaled $8,137,889.

The following table summarizes the results of our statistical sampling:

Known excess vacation and annual leave balances	$ 650,502
Divide by: Sample	650,502
Error rate for projection	100.00%
Population that was statistically sampled	8,137,889
Multiply by: Error rate for projection	100.00%
Known and likely excess vacation and annual leave balances	8,137,889
Less: Known excess vacation and annual leave balances	650,502
Likely excess vacation and annual leave balances	$ 7,487,387

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

[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.

If DWR does not take action to reduce the excess leave balances, the liability for accrued vacation and annual leave will likely increase 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. The state agency responsible for paying these leave balances may face a cash flow problem if a significant number of employees with excessive vacation or annual leave balances separate from state service. Normally, state agencies are not budgeted to make these separation lump-sum payments. However, the State's current practice dictates that the state agency that last employed an employee pays for that employee's lump-sum separation payment, regardless of where the employee accrued the leave balance.

Recommendation

We recommend that DWR:

- Implement controls, including existing policies and procedures, 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 overtime pay, resulting in improper and questioned payments

DWR lacked adequate controls over the processing of overtime pay. We identified $133,623 in overpayments, $48 in underpayments, and $669 in questioned payment for overtime, consisting of $7,320 in overpayments, $48 in underpayments, and $669 in questioned payment based on actual transactions examined ("known"); and $126,303 in overpayments based on the results of statistical sampling ("likely"). If not mitigated, these control deficiencies leave DWR at risk of additional improper payments for overtime.

Collective bargaining agreements, and state laws and policies, contain specific clauses regarding overtime pay. Payroll records show that DWR processed 32,944 overtime pay transactions, totaling $55,005,985, between August 2015 and July 2018, as follows:

Overtime Payment Type by Group	Unit	Amount
Work Week Group E (items examined 100%)	64	$ 125,820
Work Week Group 2 – Overtime pay for July 2018 (randomly selected items for examination)	111	110,816
Work Week Group 2 – Paid for at least 250 hours (items examined 100%)	11	180,936
Work Week Group 2 – Paid for less than 250 hours (statistically sampled)	32,758	54,588,413
Total population	32,944	$ 55,005,985

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

We examined all 64 overtime pay transactions, totaling $125,820, for Work Week Group (WWG) E employees, who are not eligible to receive overtime pay under normal circumstances. Of the 64 transactions, DWR overpaid 12 of them by approximately $6,944. The overpayments occurred because the payroll transactions unit staff members made payments to employees who were not eligible to receive overtime pay.

The California Department of Human Resources' (CalHR) *California State Civil Service Pay Scales*, section 10 states, in part:

> Work Week Group "E" includes classes that are exempted from coverage under the FLSA 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. Work Week Group 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 all 11 overtime pay transactions, totaling $180,936, for WWG 2 employees who were paid for at least 250 hours of overtime. Of the 11 transactions, we questioned one of them, totaling $669, because DWR could not provide the employee's timesheet to support that the payment was valid and authorized.

Of the 111 overtime pay transactions, totaling $110,816, for overtime worked in July 2018, we randomly selected 10 transactions, totaling $8,887. Of the 10 overtime pay transactions, one was underpaid by $48 because the payroll transactions staff miscalculated the salary rate used to pay for overtime.

Of the 32,758 overtime pay transactions, totaling $54,588,413, for WWG 2 employees who were paid for less than 250 hours of overtime, we randomly selected a statistical sample (as described in the Appendix) of 105 transactions, totaling $162,116. Of the 105 transactions, DWR overpaid three of them by approximately $376. As we used a statistical sampling method to select the overtime pay transactions examined, we projected the amount of likely overpayments to be $126,303. Accordingly, the known and likely overpayments totaled $126,679.

The following table summarizes the results of our statistical sampling:

Known overpayments	$ 376
Divide by: Sample	162,116
Error rate for projection (differences due to rounding)	0.23%
Population that was statistically sampled	54,588,413
Multiply by: Error rate for projection	0.23%
Known and likely overpayments (differences due to rounding)	126,679
Less: Known overpayments	376
Likely overpayments	$ 126,303

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

The known overpayments were made because payroll transactions unit staff members miscalculated overtime hours worked, incorrectly paid hours worked at the time-and-a-half rate instead of the straight-time rate, and incorrectly entered overtime pay into the payroll system. DWR 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 DWR:

- 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 and questioned payments for overtime pay from recurring, DWR:

- Establish adequate internal controls to ensure that payments are accurate and comply with collective bargaining agreements and state laws and policies;
- Provide adequate oversight to ensure that payroll transactions unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies; and
- Maintain documentation supporting payments pursuant to retention policies.

FINDING 5— Inadequate controls over leave buy-back, resulting in improper and questioned payments

DWR lacked adequate controls over the processing of payments for leave buy-back. We identified $6,047 in overpayments, $5,708 in underpayments, and $313,943 in questioned payments for leave buy-back, consisting of $450 in overpayments, $425 in underpayments, and $23,391 in questioned payments based on actual transactions reviewed (“known”); and $5,597 in overpayments, $5,283 in underpayments, and $290,552 in questioned payments based on the results of statistical sampling (“likely”). If not mitigated, these control deficiencies leave DWR at risk of additional improper leave buy-back payments.

A leave-buy back occurs when an employee receives payment at the regular salary rate in exchange for accrued vacation, annual leave, personal leave, personal holiday, and/or holiday credits. Collective bargaining agreements between the State and the Collective Bargaining Units 1, 2, 4, 9, 10, 11, and 12 allow for the annual cash-out of a certain number of hours of accumulated vacation and annual leave if funds are available. Title 2, *California Code of Regulations*, section 599.744 also provides that CalHR may authorize a leave buy-back program for employees excluded from collective bargaining. CalHR authorized leave buy-backs for excluded employees in fiscal year (FY) 2015-16, FY 2016-17, and FY 2017-18. It also provided the State's policies and procedures regarding cash-out of vacation and annual leave.

Payroll records show that DWR processed 1,407 leave buy-back transactions, totaling $5,339,295, between August 2015 and July 2018. Of these transactions, we randomly selected a statistical sample (as described in the Appendix) of 105, totaling $397,819. Our examination of the 105 transactions determined that DWR overpaid two of them by $450 and underpaid four of them by $425. We also questioned seven transactions, totaling $23,391, because DWR could not provide the required documentation to support that the payments were valid and authorized. Without the supporting documentation, there is no record of employees' election for leave buy-back, and the required review and approval of the payment. Therefore, we could not determine the validity and propriety of payments for these seven leave buy-back transactions. The known improper and questioned payments totaled a net of approximately $23,416.

As we used a statistical sampling method to select the leave buy-back transactions examined, we projected the amount of likely overpayments to be $5,597 and likely underpayments to be $5,283. We could also estimate that there may have been additional missing supporting documentation associated with leave buy-back, totaling $290,552. As supporting documentation is necessary to authorize pay, we would also question these payments for leave buy-back. The likely improper and questioned payments totaled a net of approximately $290,866. Therefore, the known and likely improper and questioned payments totaled a net of approximately $314,282, consisting of $6,047 in overpayments, $5,708 in underpayments, and $313,943 in questioned payments.

The following table summarizes the results of our statistical sampling:

Known improper and questioned payments, net	$ 23,416
Divide by: Sample	397,819
Error rate for projection (differences due to rounding)	5.89%
Population that was statistically sampled	5,339,295
Multiply by: Error rate for projection	5.89%
Known and likely improper and questioned payments, net (differences due to rounding)	314,282
Less: Known improper and questioned payments, net	23,416
Likely improper and questioned payments, net	$ 290,866

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

The known improper payments were made because payroll transactions unit staff members miscalculated leave buy-back payments and incorrectly entered payments into the payroll system. DWR also lacked adequate supervisory review to ensure accurate processing of leave buy-back transactions.

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 DWR:

- Conduct a review of payments for leave buy-back 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 and questioned leave buy-back payments from recurring, DWR:

- Establish adequate internal controls to ensure that payments for leave buy-back are accurate, and comply with collective bargaining agreements and state laws and policies;
- Provide adequate oversight to ensure that payroll transactions unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies; and
- Maintain documentation supporting payments pursuant to retention policies.

FINDING 6— Inadequate controls over separation lump-sum pay, resulting in improper payments

DWR lacked adequate controls over the processing of employee separation lump-sum pay. We identified $57,099 in overpayments and $96,722 in underpayments for separation lump-sum pay, consisting of $11,017 in overpayments and $20,121 in underpayments based on actual transactions examined ("known"); and $46,082 in overpayments and $76,601 in underpayments based on the results of statistical sampling ("likely"). If not mitigated, the control deficiencies leave DWR at risk of additional improper separation lump-sum 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.

Payroll records show that DWR processed payments for separation lump-sum pay, totaling $16,778,108, for 642 employees between August 2015 and July 2018, as follows:

Separation Lump-sum Pay Group	Unit	Amount
Employees who were paid at least $150,000 (items examined 100%)	14	$ 2,532,258
Employees who were paid less than $150,000 (statistically sampled)	628	14,245,850
Total population	642	$ 16,778,108

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

We examined the separation lump-sum pay for the 14 employees with the highest payments, totaling $2,532,258. Of the 14 employees, DWR overpaid one of them by approximately $35 and underpaid three of them by approximately $1,865.

Of the remaining 628 payments to employees, totaling $14,245,850, we randomly selected a statistical sample (as described in the Appendix) of 105 employees who received separation lump-sum pay, totaling $2,741,744. Our examination of lump-sum payments made to these 105 employees showed that DWR overpaid 10 of them by approximately $10,982 and underpaid 17 of them by approximately $18,256. These payments resulted in net total improper payments of $7,274.

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 $46,082 and likely underpayments to be $76,601. These payments resulted in net total improper payments of $30,519. Therefore, the known and likely improper payments totaled a net of approximately $37,793, consisting of $57,064 in overpayments and $94,857 in underpayments.

The following table summarizes the results of our statistical sampling:

Known improper payments, net	$ (7,274)
Divide by: Sample	2,741,744
Error rate for projection (differences due to rounding)	(0.27%)
Population that was statistically sampled	14,245,850
Multiply by: Error rate for projection	(0.27%)
Known and likely improper payments, net (differences due to rounding)	(37,793)
Less: Known improper payments, net	(7,274)
Likely improper payments, net	$ (30,519)

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

The known improper payments were made because payroll transactions unit staff members miscalculated leave balances paid. DWR also lacked adequate supervisory review to ensure accurate processing of separation lump-sum pay.

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

<u>Recommendation</u>

We recommend that DWR:

- Establish adequate controls to ensure accurate calculation and payment of separation lump-sum pay;

- Conduct a review of separation lump-sum payments 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 7— Inadequate controls over salary advances, resulting in failure to properly issue and recover outstanding amounts

DWR lacked adequate controls over salary advances to ensure that advances were issued and recovered in accordance with state law and policies. Three salary advances, totaling $10,246, were issued without proper review and approval. One unrecovered salary advance, with a balance of $253, was outstanding for over 12 years. This control deficiency leaves DWR at risk of further failures to properly issue and collect salary advances if not mitigated.

At July 31, 2018, DWR's accounting records showed eight outstanding salary advances, totaling $27,292, including one balance of $253 that was outstanding for more than 120 days. 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.

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

We examined four of the eight outstanding salary advances, totaling $10,499. Three of the four salary advances, totaling $10,246, had not been reviewed and approved by an authorized individual. DWR's *Enterprise Process Guide - Accounts Payable 1: Requesting a Salary Advance* states, in part:

> Chief, Payroll, Benefits and SAP Administration...Reviews and approves the request by signing and dating page two of the DWR 408, and returns the request to the Personnel Supervisor for processing of the salary advance. . . .

In addition, DWR could not provide supporting documentation for one of the four salary advances, with a balance of $253. This salary advance has been outstanding for over 12 years. SAM section 8776 requires agencies to maintain proper records of collection efforts and payment of salary advances.

We also noted that that DWR's policies do not require the cancellation of direct deposit before an employee receives a salary advance. This creates a risk of overpayment because employees could receive salary advances and their regular pay at the same time.

SCO's *Payroll Procedures Manual*, section J 008 states, in part:

> Agencies/campuses should not issue a salary advance to an employee who has an active Direct Deposit. An agency/campus should first submit a STD. 699 to cancel the employee's Direct Deposit before an advance is issued. . . .

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.

<u>Recommendation</u>

We recommend that DWR:

- Issue salary advances in accordance with existing policies and procedures;
- 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—
Audit Sampling Methodology
August 1, 2015, through July 31, 2018

We used attributes sampling for tests of compliance. The following table outlines our audit sampling application for audit areas that included errors:

Audit Area	Type of Test	Population (Unit)	Population (Dollar)	Sampling Unit	Sample Selection Method	Confidence Level	Tolerable Error Rate	Expected Error (Rate) [1]	Sample Size	Results Projected to Intended Population	Finding Number
Excess vacation and annual leave balances	Compliance	472	$ 8,137,889	Employee	Computer-generated simple random	90%	5%	0 (0%)	45	Yes	3
Overtime pay (Work Week Group 2 – Paid for less than 250 hours)	Compliance	32,758	$ 54,588,413	Payment transactions	Computer-generated simple random	90%	5%	2 (1.75%)	105	Yes	4
Leave buy-back	Compliance	1,407	$ 5,339,295	Payment transactions	Computer-generated simple random	90%	5%	2 (1.75%)	105	Yes	5
Separation lump-sum pay	Compliance	628	$ 14,245,850	Employee	Computer-generated simple random	90%	5%	2 (1.75%)	105	Yes	6

[1] Pursuant to the AICPA'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 error.

Attachment—
California Department of Water Resources's Response to Draft Audit Report

STATE OF CALIFORNIA – CALIFORNIA NATURAL RESOURCES AGENCY

GAVIN NEWSOM, Governor

DEPARTMENT OF WATER RESOURCES
1416 NINTH STREET, P.O. BOX 942836
SACRAMENTO, CA 94236-0001
(916) 653-5791

June 28, 2019

Mr. Andrew Finlayson
State Agency Audits Bureau
State Controller's Office
P.O. Box 942850
Sacramento, California 94250

Dear Mr. Finlayson:

The Department of Water Resources (DWR) reviewed the draft report and agrees with all the findings. DWR commits to reviewing its current policy and procedures and will take necessary steps to ensure compliance.

If you have any questions, or would like to discuss, please contact Jennifer Dong Kawate, Chief of the Human Resources Office, at (916) 651-0860.

Sincerely,

KS Kishaba

Katherine S. Kishaba
Deputy Director, Business Operations

cc: Jennifer Dong Kawate, Chief, Human Resources Office
David Whitsell, Chief, Internal Audits Office

State Controller's Office
Division of Audits
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