

STATE TREASURER'S OFFICE

Audit Report

PAYROLL AUDIT

January 1, 2016, through December 31, 2018



BETTY T. YEE
California State Controller

November 2020



BETTY T. YEE
California State Controller

November 3, 2020

Fiona Ma, CPA, California State Treasurer
State Treasurer's Office
915 Capitol Mall, Suite 110
Sacramento, CA 95814

Dear Treasurer Ma:

The State Controller's Office audited the State Treasurer's Office (STO) payroll process and transactions for the period of January 1, 2016, through December 31, 2018. STO 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.

Our audit determined that STO did not maintain adequate and effective internal controls over its payroll process. STO lacked adequate segregation of duties and compensating controls over payroll transactions, resulting in improper separation lump-sum, overtime, and leave buy-back payments. STO also granted inappropriate keying access to the State's payroll system.

In addition, STO did not implement controls to limit the accumulation of vacation and annual leave credits, resulting in liability for excessive balances.

STO administered salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

If you have any questions, please contact Andrew Finlayson, Chief, State Agency Audits Bureau, by telephone at (916) 324-6310, or by email at afinlayson@sco.ca.gov.

Sincerely,

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

JLS/as

cc: Genevieve Jopanda, Chief Deputy Treasurer
State Treasurer's Office
Rebecca Grajski, Administration Division Director
State Treasurer's Office
Christopher Sneed, Chief of Management Services
State Treasurer's Office
Mark Rodriguez, Chief, Administrative Services Division
California Department of Human Resources
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Audit Report

Summary

The State Controller's Office (SCO) audited the State Treasurer's Office (STO) payroll process and transactions for the period of January 1, 2016, through December 31, 2018. STO 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 June 24, 2020.

Our audit determined that STO:

- Did not maintain adequate and effective internal controls over its payroll process. STO lacked adequate segregation of duties and compensating controls over payroll transactions, resulting in improper separation lump-sum, overtime, and leave buy-back payments. STO also granted inappropriate keying access to the State's payroll system;
- Did not implement controls to limit the accumulation of vacation and annual leave credits, resulting in liability for excessive balances; and
- Administered salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

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:

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 STO:

- 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 January 1, 2016, through December 31, 2018.

The audit population consisted of payroll transactions totaling \$53,390,345, as quantified in the Schedule.

To achieve our audit objectives, we:

- Reviewed state and STO policies and procedures related to the payroll process to understand STO's methodology for processing various payroll and payroll-related transactions;
- Interviewed STO payroll personnel to understand STO's methodology for processing various payroll and payroll-related transactions, determine employees' 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 STO 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 STO:

- 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:
 - Inadequate segregation of duties and a lack of compensating controls over payroll transactions (see Finding 1);
 - Inappropriate keying access to the State's payroll system (see Finding 2);
 - Failure to implement controls to ensure that STO adhered 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 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, resulting in improper payments (see Finding 5);
 - Inadequate controls to ensure that leave buy-backs were calculated correctly, resulting in improper payments (see Finding 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:

¹ In planning and performing our audit of compliance, we considered STO'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; it was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. As discussed in 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 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.

- Excessive vacation and annual leave balances with a value of at least \$1,022,695 as of December 31, 2018 (see Finding 3);
- Improper and late payments for employee separation lump-sum pay (see Finding 4), improper payments for overtime pay (see Finding 5), and improper payments for leave buy-back (see Finding 6), costing an estimated net total of \$2,147; and
- Administered salary advances in accordance with collective bargaining agreements and state laws, regulations, policies, and procedures.

Follow-up on Prior Audit Findings

The California State Personnel Board issued a report on April 13, 2018, on its Compliance Review of STO from April 1, 2016, through December 31, 2016. The California State Personnel Board report did not include findings that directly relate to the objectives of our audit. Therefore, a follow-up was not necessary.

Views of Responsible Officials

We issued a draft audit report on September 28, 2020. Christopher Sneed, Chief of Management Services responded by letter dated October 13, 2020 (Attachment), acknowledging Findings 2, 4, 5, and 6 and indicating that STO has taken steps to correct the deficiencies noted. We will follow up during the next payroll audit to verify that these corrective actions were adequate and appropriate. STO also provided additional information regarding Findings 1 and 3. Our comments on STO's response to Findings 1 and 3 are included in the Findings and Recommendations section.

Restricted Use

This audit report is solely for the information and use of STO 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

November 3, 2020

**Schedule—
Summary of Audit Results
January 1, 2016, through December 31, 2018**

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	Net Total Dollar Amount of Known and Likely Issues	Finding Number
Segregation of duties	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1
System access	Targeted	7	N/A	7	Employee	N/A	N/A	2
Excess vacation and annual leave	Targeted	47	\$ 1,022,695	47	Employee	\$ 1,022,695	\$ 1,022,695	3
Separation lump-sum pay	Targeted	29	487,984	29	Employee	487,984	(1,074)	4
Overtime pay	Statistical and targeted	204	122,727	64	Transaction	46,497	(879)	5
Leave buy-back	Targeted	107	387,924	107	Transaction	387,924	(194)	6
Regular pay	Statistical	8,344	51,257,075	45	Transaction	-	-	
Holiday credit	Targeted	333	108,208	333	Transaction	-	-	
Salary advance	Targeted	2	3,732	2	Transaction	-	-	
			\$ 53,390,345			\$ 1,945,100	\$ 1,020,548	

Findings and Recommendations

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

STO lacked adequate segregation of duties within its payroll transactions unit to ensure that only valid and authorized payroll transactions were processed. STO 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 STO 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. STO failed to demonstrate that it 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 STO 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 6, represent a material weakness in internal control over the payroll process such that there is a reasonable possibility that a 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 STO:

- 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, STO 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.

STO's Response

The Senior Personnel Specialist duties and responsibilities consist of processing various personnel/payroll transactions, including: data entry, reconciliation, and processing of adjustments and corrections. During the audit period, the STO had one of its two transactions staff positions vacant due to the previous employee transferring to another State agency. STO believes controls are in place which ensure duties are performed accurately, including but not limited to the two Senior Personnel Specialists verifying the accuracy of each other's work.

SCO Comment

Our finding remains unchanged.

We appreciate STO's response regarding the existence of compensating controls over the processing of payroll transactions. As discussed in the finding, we found that STO lacked adequate segregation of duties and compensating controls within its payroll transactions unit. STO's response did not dispute that STO payroll transactions unit staff performed conflicting duties. The response asserts, however, the existence of compensating controls to mitigate the risk associated with the lack of adequate segregation of duties. This assertion is unsupported. STO stated that two Senior Personnel Specialists verified the accuracy of one another's work. This activity, if performed effectively, provides prudent detective control to ensure Senior Personnel Specialists key data accurately into the system; however, as discussed in the finding, we found no evidence that such activity existed during our audit. STO did not provide in its response additional documents to support its assertion.

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

STO lacked adequate controls to ensure that only appropriate staff had keying access to the State's payroll system. STO inappropriately allowed five 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 seven STO employees who had keying access to the State's payroll system at various times between January 2016 and December 2018. Of the seven employees, five had inappropriate keying access to the State's payroll system. Specifically, STO did not immediately remove or modify keying access for the five employees after the employees' separation from state service, transfer to another agency, or change in classification. For example, a Personnel Specialist left STO on March 24, 2017; however, STO did not request to remove the employee's access until April 27, 2017, 34 days later.

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 STO:

- Update keying access to the State's payroll system immediately after employees leave STO, 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**

STO failed to 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 liability for excessive leave balances with a value of at least \$1,022,695 as of December 31, 2018. We expect the liability to increase if STO 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 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 STO's leave accounting records determined that STO had 209 employees with unused vacation or annual leave credits at December 31, 2018. Of those employees, 47 exceeded the limit set by collective bargaining agreements and state regulations. For example, one employee had an accumulated balance of 2,184 hours in annual leave, or 1,544 hours beyond the 640-hour limit. Collectively, the 47 employees accumulated 19,435 hours of excess vacation and annual leave, with a value of at least \$1,022,695 as of December 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 this liability will be higher. For example, a STO employee separated from state service with 1,941 hours in leave credits, including 1,829 hours in annual leave. After adjusting for additional leave credits, the employee was paid for 2,313 hours, or 19% more.

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.

We also examined the records of the 47 employees to determine whether STO complied with collective bargaining agreements and state regulations. We determined that STO 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.

Although we were able to verify that STO had plans in place during the audit period to reduce leave balances below the limit, this control activity was not operating effectively. STO policy requires employees to submit leave reduction plans by July 31 each year, two months after the deadline set by collective bargaining agreements. In addition, the average hours of excess vacation and annual leave increased every year during the audit period. Furthermore, two of the 47 employees who exceeded the limit did not have leave reduction plans in place during the audit period.

If STO does not take action to reduce the excessive 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, thus 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 separation lump-sum payment, regardless of where the employee accrued the leave balance.

Recommendation

We recommend that STO:

- 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.

STO's Response

In 2018, the STO began providing quarterly reports to its management team in an effort to assist them with monitoring excess leave balances. Additionally, on a regular basis, the STO has: (1) required all supervisory staff to monitor their employees' vacation/annual leave balances for excess time; (2) encouraged staff to use excess time in the pay period accrued when possible; (3) required the completion of an annual reduction plan for staff with excess leave balances; and (4) participated in the leave buyback program, when possible and available.

SCO Comment

Our finding remains unchanged.

We appreciate STO's response regarding the actions it has taken to address the excessive leave balances. As discussed in the finding, we found that STO failed to 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. STO's response did not dispute that it 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. The response stated that STO required the completion of an annual reduction plan for employees with excessive leave balances; however, this activity was not operating effectively. As stated in the finding, 47 employees exceeded the limit for vacation and annual leave. Two of the 47 employees did not have leave reduction plans in place during the audit period.

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

STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of employee separation lump-sum pay. STO lacked adequate supervisory review to ensure accurate and timely processing of separation lump-sum pay. If not mitigated, these control deficiencies leave STO at risk of making improper and late separation lump-sum payments, noncompliance with agreements and laws, and liability for late payments.

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

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.

Our examination of separation lump-sum pay determined improper payments. Although the improper payments were deemed insignificant, the existence of control deficiencies over the processing of separation lump-sum pay present the risk that STO will not prevent, or detect and correct, improper payments in a timely manner. Payroll records show that STO processed separation lump-sum payments, totaling \$487,984, for 29 employees between January 2016 and December 2018. We examined the separation lump-sum payments for all 29 employees and found that STO overpaid one by approximately \$57 and underpaid two by an approximate total of \$1,131. These errors resulted in net total underpayments of \$1,074. The improper payments were made because payroll transactions unit staff members miscalculated leave balances.

Of the 29 employees whose separation lump-sum payments we examined, 10 were not paid in a timely manner, in violation of collective bargaining agreements and state laws, as summarized in the California Department of Human Resources' (CalHR) *Human Resources Manual*, section 1703.

Recommendation

We recommend that STO:

- Establish adequate controls to ensure accurate calculation and timely payment of separation lump-sum pay; and
- Recover overpayments made to separated employees in accordance with GC section 19838 and *State Administrative Manual* section 8776.6, and properly compensate those employees who were underpaid.

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

STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of overtime pay. STO lacked adequate supervisory review to ensure accurate processing of overtime pay. If not mitigated, these control deficiencies leave STO at risk of making additional improper payments for overtime.

GC sections 13400 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.

Collective bargaining agreements, and state laws and policies, contain specific clauses regarding overtime pay.

Our examination of overtime pay determined improper payments. Although the improper payments were deemed insignificant, the existence of control deficiencies over the processing of overtime pay present the risk that STO will not prevent, or detect and correct, improper payments in a timely manner. Payroll records show that STO processed 204 overtime pay transactions, totaling \$122,727, between January 2016 and December 2018, as follows:

<u>Overtime Payment Type by Group</u>	<u>Unit</u>	<u>Amount</u>
Work Week Group 2 - Paid for 100 hours or less per transaction (statistically sampled)	202	\$ 114,041
Work Week Group 2 - Paid for more than 100 hours per transaction (items examined 100%)	2	8,686
Total population	<u>204</u>	<u>\$ 122,727</u>

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

Of the 202 overtime pay transactions, totaling \$114,041, for Work Week Group 2 employees who were paid for 100 hours or less of overtime per transaction, we randomly selected a statistical sample (as described in the Appendix) of 62 transactions, totaling \$37,811. Of the 62 transactions, three were overpaid by approximately \$404 and eight were underpaid by approximately \$695. These payments resulted in a net total of \$291 in underpayments.

As we used a statistical sampling method to select the overtime pay transactions examined, we projected the amount of likely overpayments to be \$814 and likely underpayments to be \$1,402. These payments resulted in a net total of \$588 in likely underpayments. Therefore, the known and likely underpayments totaled a net of approximately \$879, consisting of \$1,218 in overpayments and \$2,097 in underpayments

The following table summarizes the results of our statistical sampling:

Known underpayments, net	\$ 291
Divide by: Sample	37,811
Error rate for projection (differences due to rounding)	<u>0.77%</u>
Population that was statistically sampled	114,041
Multiply by: Error rate for projection	0.77%
Known and likely underpayments, net (differences due to rounding)	<u>879</u>
Less: Known underpayments, net	291
Likely underpayments, net	<u>\$ 588</u>

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

We also examined the two overtime pay transactions, totaling \$8,686, for Work Week Group 2 employees who were paid for more than 100 hours of overtime per transaction. Our examination of the transactions found no exceptions.

The known improper payments were made because payroll transactions unit staff members miscalculated overtime hours worked; or paid for overtime hours worked at the straight-time rate instead of the time-and-a-half rate, or vice-versa.

Recommendation

We recommend that STO:

- 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 payments for overtime pay from recurring, STO:

- 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 payroll transactions unit staff process only valid and authorized payments that comply with collective bargaining agreements and state laws and policies.

**FINDING 6—
Inadequate
controls over leave
buy-back, resulting
in improper
payments**

STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of leave buy-back. STO lacked adequate supervisory review to ensure accurate and timely processing of leave buy-back. If not mitigated, these control deficiencies leave STO at risk of making additional improper leave buy-back payments.

GC sections 13400 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.

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 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.

Our examination of leave buy-back determined improper payments. Although the improper payments were deemed insignificant, the existence of control deficiencies over the processing of leave buy-back present the risk that STO will not prevent, or detect and correct, improper payments in a timely manner. Payroll records show that STO processed 107 leave buy-back transactions, totaling \$387,924, between January 2016 and December 2018. We examined all 107 leave buy-back transactions and found that STO overpaid two by approximately \$297, and underpaid three by approximately \$491. These errors resulted in net total underpayments of \$194. The improper payments were made because payroll transactions unit staff members failed to reduce leave balances in the leave accounting system or used incorrect salary rates.

Recommendation

We recommend that STO:

- 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; and
- To prevent improper leave buy-back payments from recurring, establish adequate internal controls, including oversight of payroll transactions unit staff, to ensure that payments for leave buy-back are accurate, and comply with collective bargaining agreements and state laws and policies.

Appendix— Audit Sampling Methodology

We used attributes sampling for tests of compliance. The sample design was chosen because:

- It follows the American Institute of Certified Public Accountants (AICPA) guidelines;
- It allows us to achieve our objectives for tests of compliance in an efficient and effective manner; and
- Audit areas included both high and low volumes of transactions.

The following table outlines our audit sampling application for all audit areas where statistical sampling was utilized:

Audit Area	Type of Test	Population (Unit)	Population (Dollar)	Sampling Unit	Sample Selection Method	Confidence Level	Tolerable Error Rate	Expected Error (Rate) ^a	Sample Size ^b	Results Projected to Intended Population	Finding Number
Regular pay	Compliance	8,344	\$51,257,075	Transaction	Computer-generated simple random	90%	5%	0 (0.00%)	45	Yes	
Overtime pay (Work Week Group 2 - Paid for 100 hours or less per transaction)	Compliance	202	114,041	Transaction	Computer-generated simple random	90%	5%	2 (0.75%)	62	Yes	5

^a 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 1.0 error.

^b For populations of fewer than 250 items, we determined the sample size using a calculator that uses a hypergeometric distribution. For populations of 250 items or more, we determined the sample size using a calculator that uses a binomial distribution. As stated in *Technical Notes on the AICPA Audit Guide Audit Sampling* (March 1, 2012), page 5, although the hypergeometric distribution is the exactly correct distribution to use for attributes sample sizes, the distribution becomes unwieldy for large populations unless suitable software is available. Therefore, more convenient approximations are frequently used instead.

**Attachment—
State Treasurer's Office's
Response to Draft Audit Report**

OFFICE OF THE TREASURERP. O. BOX 942809
SACRAMENTO, CA 94209-0001

October 13, 2020

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

Mr. Finlayson,

Response to Payroll Audit Report

This letter is in response to the draft report issued by the State Controller's Office (SCO) on September 28, 2020 regarding the Payroll Process Review of the State Treasurer's Office (STO). The STO takes seriously its responsibilities to ensure effective payroll processes are in place, and is committed to continually improving these processes. This commitment is demonstrated by the enhanced quality controls put in place since the audit period of January 1, 2016 through December 31, 2018. Specifically, the STO believes improvements have been made via procedural changes, staff training, and ongoing process evaluation. The STO continues to place importance on the quality of work of the Personnel Transactions Office and is looking forward to continuing to improve.

The STO appreciates and welcomes the insights provided by the auditors and would like to thank the SCO for its work on this report. Attachment A addresses each finding and accompanying recommendation contained in the report.

Thank you for the opportunity to respond to the draft report. If you have any questions, or require additional information, please do not hesitate to contact me at (916) 653-3382, or by email at csneed@treasurer.ca.gov.

Sincerely,

A handwritten signature in blue ink, appearing to read "Chris Sneed", written over a light blue circular stamp.

Christopher Sneed
Chief of Management Services

Enclosure

cc: Fiona Ma, CPA, California State Treasurer
Genevieve Jopanda, Chief Deputy Treasurer
Rebecca Grajski, Administration Division Director

FINDING No. 1

Inadequate segregation of duties and lack of compensating controls over payroll transactions.

Cause: STO lacked adequate segregation of duties within its payroll transactions unit to ensure that only valid and authorized payroll transactions were processed. STO also failed to implement other controls to compensate for this risk.

Department's Response: The Senior Personnel Specialist duties and responsibilities consist of processing various personnel/payroll transactions, including: data entry, reconciliation, and processing of adjustments and corrections. During the audit period, the STO had one of its two transactions staff positions vacant due to the previous employee transferring to another State agency. STO believes controls are in place which ensure duties are performed accurately, including but not limited to the two Senior Personnel Specialists verifying the accuracy of each other's work.

FINDING No. 2

Inappropriate keying access to the State's payroll system.

Cause: STO lacked adequate controls to ensure that only appropriate staff had keying access to the State's payroll system. STO inappropriately allowed five 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.

Department's Response: Since the SCO's review, the STO has implemented procedures to timely remove SCO users who are transferring or separating. The STO now submits the necessary paperwork (PSD125A) to the SCO the day after an employee transfers or separates from the department.

FINDING No. 3

Inadequate controls over vacation and annual leave balances, resulting in liability for excessive balances.

Cause: STO 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. This deficiency resulted in liability for excessive leave balances with a value of at least \$1,022,695 as of December 31, 2018. We expect the liability to increase if STO does not take action to address the excessive vacation and annual leave balances.

Department's Response: In 2018, the STO began providing quarterly reports to its management team in an effort to assist them with monitoring excess leave balances. Additionally, on a regular basis, the STO has: (1) required all supervisory staff to monitor their employees' vacation/annual leave balances for excess time; (2) encouraged staff to use excess time in the pay period accrued when possible; (3) required the completion of an annual reduction plan for staff with excess leave balances; and (4) participated in the leave buyback program, when possible and available.

FINDING No. 4

Inadequate controls over separation lump-sum pay, resulting in improper and late payments.

Cause: STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of employee separation lump-sum pay. STO lacked adequate supervisory review to ensure accurate and timely processing of separation lump-sum pay. If not mitigated, these control deficiencies leave STO at risk of making improper and late separation lump-sum payments, noncompliance with agreements and laws, and liability for late payments.

Department's Response: STO has implemented oversight controls which require review and signature approval of lump sum calculations by the Senior Personnel Specialists. This should alleviate any future errors that might not otherwise be caught.

FINDING No. 5

Inadequate controls over overtime pay, resulting in improper payments.

Cause: STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of overtime pay. STO lacked adequate supervisory review to ensure accurate processing of overtime pay. If not mitigated, these control deficiencies leave STO at risk of making additional improper payments for overtime.

Department's Response: The STO has implemented oversight controls which require review and signature approval of overtime pay by the Senior Personnel Specialists. This will alleviate any future errors.

FINDING No. 6

Inadequate controls over leave buy-back, resulting in improper payments.

Cause: STO lacked adequate segregation of duties within its payroll transactions unit, as noted in Finding 1, and lacked adequate controls over the processing of leave buy-back. STO lacked adequate supervisory review to ensure accurate and timely processing of leave buy-back. If not mitigated, these control deficiencies leave STO at risk of making additional improper leave buy-back payments.

Department's Response: The STO has implemented oversight controls which require review and signature approval of leave buy-back pay by the Senior Personnel Specialists. This will alleviate any future errors.

**State Controller's Office
Division of Audits
Post Office Box 942850
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<http://www.sco.ca.gov>