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September 13, 2016

OFFICE OF THE MAYOR
HONORABLE CITY COUNCILMEMBERS
CITY ADMINISTRATOR
CITIZENS OF OAKLAND
OAKLAND, CALIFORNIA

RE: Payroll Audit & Review of Internal Controls Report

Dear Mayor Schaaf, President McElhaney, Members of the City Council, City Administrator Landreth, and Oakland Citizens:

The City maintains a decentralized timekeeping/payroll function that encompasses multiple departments for its approximately 5,100 full and part-time employee workforce and pays out \$571 million in annual compensation. As such, it is important to periodically review the current payroll practices in place for efficiencies, security and effective internal controls.

The objective of this audit was to confirm that efficiencies and appropriate controls are sufficiently in place and functioning as intended in order to meet the organizational goals for ensuring accurate, timely and appropriately authorized transactions.

The audit provides for recommendations that are intended to assist the City in supporting Payroll Operations and developing action plans for improvement. Specifically, our recommendations call for the following:

- Strengthen controls around timekeeping and the authorization of approvals of timecards,
- Designating Payroll Operations to serve as the central and primary entity, to establish the framework of internal controls for the City's payroll functions, and
- Revising and updating the City's procedures to reflect current practices

I want to express our appreciation to the Payroll Operations management and staff for their cooperation during this audit. Their continuing commitment to the mission of quality improvement in Internal Controls for Payroll Operations is recognized as they provide payroll services to the employees of the City of Oakland.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "Brenda D. Roberts". The signature is fluid and cursive, with a long horizontal stroke extending from the end.

BRENDA D. ROBERTS, CPA, CFE, CIA
City Auditor

City Auditor
Brenda Roberts
CPA

September 13, 2016

Payroll Audit & Review of Internal Controls Report



Audit Team:

Stephen Lawrence
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Assistant City Auditor

Mary Seymour, CIA
*Performance Audit
Manager*



CITY OF OAKLAND

OFFICE OF THE CITY AUDITOR

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I. Introduction

The City of Oakland (City) is the fifth largest employer in Oakland with over 5,000 employees. Given the size of the City's payroll and the impact of spending on the annual budget, it is essential for the City to maintain strong controls over its payroll processes and procedures. This is to ensure employees are paid accurately and appropriately, and that sensitive employee information remains protected. Effective payroll controls are a necessary component to any efficient organization. Consequently, the City Auditor conducted this audit to assess the internal controls over the City's payroll processes.

Background

The City maintains a decentralized timekeeping/payroll function that encompasses multiple departments for its approximately 5,100 full and part-time employee workforce and pays out \$571 million in annual compensation. Timekeeping in the various departments is submitted by either the Oracle timekeeping module or manually on paper. However, all wages are centrally processed by Payroll Operations, which is part of Treasury operations located within the Finance & Management department.

Payroll Operations:

- Processes and distributes bi-weekly payroll for all employees.
- Calculates and withholds payroll deductions for benefits and taxes.
- Makes payroll adjustments such as late timekeeping entries or error corrections.
- Enters new and eliminates terminated employees from the electronic payroll system.
- Processes year-end reports for management, and produces year-end tax documents for employees, contractors and vendors.
- Acts in compliance with applicable laws, regulations and current labor-management agreements known as Memorandums of Understanding (MOUs) in regards to specific payroll transactions.

The payroll system is part of the Oracle E-Business Suite management information system used throughout the City for financial, human resource, website management and purchasing functions. There is a city-wide project to upgrade Oracle to the latest version available; this upgrade is scheduled for completion in 2016.

The last audit of Payroll Operations was conducted in 2007. The audit report identified no issues with internal controls over the payroll function. The majority of reported audit findings centered on administrative practices such as management leave assignment, early release of paychecks, vacation buy back practices, timekeeping processes, and outdated policies and procedures. Finance & Management department management at the time disagreed with many of the findings and we note that management did not take recommended corrective actions related to administrative practices.

Some of the audit issues previously identified we confirmed in this project:

- There continues to be a need to develop and disseminate comprehensive policies and procedures for administering compensation activities.
- Ensure Administrative Instructions (AIs) comply with the terms of Memorandums of Understanding (MOUs) and that provisions are not in conflict with one another.
- Revisit and refresh all payroll, benefits and other related AIs

Other issues relating to timekeeping practices and establishing Payroll Operations as the central, primary entity to establish the internal control framework responsible for the accuracy, validity, and completeness of payroll transactions were raised in the November 2007 report. The City Auditor plans to evaluate the status of timekeeping practices in future audits that focus upon various City departments.

Audit Scope and Objectives

Our overall audit objective was to determine whether the internal controls over the City's payroll process were sufficient to ensure accurate, timely and appropriately authorized transactions. The scope of this audit included all current and former employee payroll records for the first four bi-weekly pay cycles of the 2015-16 fiscal year, which covered the period of July 1 through August 30, 2015. Additional testing of Cost of Living Adjustment transactions and retroactive pay for pay cycles in the 4th quarter of 2015 was performed.

Specifically, the audit objectives were to determine the following:

- Payroll transactions were authorized by appropriate supervisory personnel through validation of accurate timekeeping.
- Policies and procedures were current and reflected processes to implement labor-management agreements (MOUs), laws and regulatory compliance, and related payroll processes appropriately and accurately.

- Duties were appropriately separated among key personnel to prevent and reduce the risk of error or misuse in payroll transactions.
- Information Technology (IT) general access controls were observed by all personnel thereby preserving a secure and confidential system for the payroll transaction environment.
- Continuous internal quality control processes existed to lower the risk of inaccurate payroll transactions.

II. Audit Results

Observation 1: Inappropriate Timekeeping Authorization:

Timekeeping authorization was inappropriately re-directed from a supervisor to a direct report.

Timekeeping controls neither prevented nor notified management that an unauthorized employee approved a timecard for their supervisor. A department manager re-designated the approval of his timecard to a subordinate. This transaction did not trigger an alert to the manager's supervisor. It also did not result in a system exception so that Payroll Operations could appropriately respond to the re-designation or escalate the issue within the manager's reporting structure. This event resulted in the transaction bypassing the normal first and secondary chain of command in place. The authorized approver was changed just prior to the timecard approval and restored to the correct authorized individual after the timecard was approved. It was by chance that this inappropriate delegation of authority in reporting was identified. The overriding of controls represents a gap in system design.

The City's policy (AI 555) and the Treasury Internal Payroll Desktop Procedures Manual stipulate that a manager's timecard be approved by the next higher level of authority rather than by a person under their supervision. Purposeful circumvention of authority controls creates opportunities for false timekeeping and inaccurate payroll transactions may go undetected. These types of transactions could be detected through a systematic quality check and automated alert processes. Other controls that could be used in detecting this type of violation include a routine review of authorization change logs before the close of the pay period. Outlier and unexpected patterns of changes then should be investigated to determine legitimacy of the changes.

The City Auditor recommends that multiple, same day authorization level changes be flagged for Payroll Operations management review so that corrective actions can be put into place as soon as possible. This course of action is in keeping with the 2007 Payroll Audit recommendation that the City needs to clearly establish Payroll Operations as the central, primary entity to establish the internal control framework responsible for the

accuracy, validity, and completeness of payroll transactions. The City Auditor recognizes that Payroll Operations already has a de facto stance in this role by their actions and leadership in quarterly meetings and training sessions for all of the individual departmental timekeeping staff. We further recommend that Payroll Operations assume responsibility over timekeeping governance by establishing and monitoring a control framework.

Observation 2: Outdated Administrative Instructions

Major payroll procedures are not yet formalized by management.

Payroll Operations operates under a draft policy titled *Administrative Instruction 555: Payroll Procedures*, which is currently in draft status but is not yet formalized by Payroll Operations. This AI has not been submitted for review and approval to the City Administrator as required. The AI 555 outlines payroll processing procedures, payroll adjustments, retroactive merit increases, processing deadlines, defines key terms, and provides a description of duties and responsibilities. According to Payroll Operations management, the AI is being revised once more to incorporate the most recent labor agreement MOU changes from November 2015. The AI will supersede the previous draft policy of 2008.

The purpose of formalized written policies and procedures is to provide approved guidance to City departments and Payroll staff regarding submission and processing of all types of payroll-related transactions. This practice ensures employees are provided accurate guidelines in the function of their duties. Without thoroughly reviewed and approved procedural guidance, there is minimal assurance that what is written is aligned with payroll practices, related laws and regulations, or is free from error or misstatement.

The City Auditor recommends the Payroll Operations prioritize the revision of *Administrative Instruction 555* and submit in a timely manner to the City Administrator for review, approval and implementation.

Observation 3: Other relevant payroll procedures maintain discrepancies

Policies and procedures are an integral part of the City's internal control environment.

Several of the City's payroll policies conflict with other City Administrative Instructions or MOUs. As seen in the table below, *Administrative Instruction 545: Vacation Leave Buy-Back and Sick Leave Buy-Back/Conversion* states the maximum allowable number of vacation days that can be sold back to Local 21 employees is 15; however, Local 21 MOU states the maximum allowable is 20 days. Similarly, *Administrative Instruction 545: Vacation Leave Buy-Back and Sick Leave Buy-Back/Conversion*, which has not been revised since 2008, states the maximum allowable number of vacation days that can be sold back to the City by Local 1245 employees is 10; however, Local 1245 MOU states the maximum allowable is 20 days.

Maximum Allowable Number of Vacation Days to be Sold Back			
Union	MOU Agreement	Administrative Instruction 545	Discrepancy
Local 21	20 days	15 days	5 days
Local 1245	20 days	10 days	10 days

Other dated AIs that provide inaccurate payroll guidance are listed in the table below:

Administrative Instruction Number	Last Date Reviewed	Issue
522: Employee Separation Procedures	March 1997	A Human Resource out-processing policy with implications for final payroll processing. The AI references mailing completed employee forms to OPRM at an address long vacated by the city. The AI does not reflect the correct department name, current address or processes.
545: Vacation and Sick Leave Buy Back	May 2008	References union Local 790, which no longer represents City employees.
516: Management, Professional and Executive Leave	May 2011	The AI references representative unit TM1 but the current MOU does not specifically state that TM1 employees receive management leave.
586: Direct Deposit and PayCard Policy	December 2010	The AI references a pay card enrollment form as an attachment, but a copy of the form is not shown in the AI nor is an attachment included to the AI.
1016: Reporting Work Time for New and Terminating Full Time Employees	July 1979	The AI describes an outdated timecard system no longer used by the City for processing a new employee's first timecard and an employee's final time card.

These discrepancies listed in the chart may lead to confusion and misunderstanding among City employees and Payroll Operations. Further, the City may payout for leave time that an employee is not entitled to receive. Inattention to maintaining current policies and procedures increases the risk of errors that have financial consequences. Employees may develop a disregard for AIs because the gulf between past practices has no bearing on current practices.

We further noted that the City AIs do not identify a departmental owner who is assigned to periodically review and update as necessary AIs under their responsibility. In our discussions with Payroll management, for example, there was disagreement as to which department should take ownership of *AI 1016 Reporting Work Time for New and Terminating Full Time Employees*. This ambiguous situation gives recurring validity to the recommendation made in November 2007 that the City needs to clearly establish Payroll Operations as the primary entity responsible for payroll controls.

The City Auditor recommends that Payroll Operations work with the City Administrator and other impacted departments in reviewing and updating those Administrative Instructions which bear on overall payroll processes. These revised and renewed policies should reflect any additional controls or changes that may result from the Oracle system upgrade underway. Furthermore, we recommend the City adopt the successful practice of assigning ownership of AIs to those department heads whose work processes are most directly impacted by an AI.

New and forthcoming automated controls help limit erroneous time and leave entry

Payroll Operations recently implemented automated controls¹ within its electronic payroll system that now prevent erroneous time entry for an employee's standard work hours, paid sick and vacation leave. As of September 2015, employees are no longer able to record hours worked in excess of their standard work hours or record hours in excess of their current leave balances. This control prevents unauthorized overtime hours being paid and prevents employees from using unearned sick or vacation leave. While department and payroll staff should continue to diligently review timecard submissions, automated controls greatly increase the processing accuracy.

¹ Automated controls are internal controls built into computer systems that limit the choices individuals can make when inputting information into a system such as time keeping entries. They may also take the form of automatic mathematical calculations so that errors in subtraction or addition, multiplication and division are avoided in calculating hourly wages or payroll deductions. (*The Institute of Internal Audit, Global Technology Audit Guide (GTAG) 8, section 1:2, p.3*)

Sample Testing Results

As part of this audit, the audit team performed sample testing to determine the accuracy and completeness of various kinds of payroll transaction controls. Nothing came to our attention, other than override of timecard approval controls as already noted, that indicated controls were not operating as intended over areas tested. Projections of control effectiveness to future periods, though, are subject to the risk that controls may become inadequate because of changes in the work environment, changes in procedures, or deterioration in employee and management compliance.

III. Other Matters for Management's Consideration

Observation 4: Quality Control Measures

In any payroll function there needs to exist a quality assurance function. As managers strive to achieve their department's missions and goals and provide accountability for their operations, they need to continually assess and evaluate their internal control structure to ensure it is well-designed and operated, appropriately updated to meet changing conditions, and provides reasonable assurance that the objectives of the department are being achieved. Specifically, managers need to examine internal control to determine how well it is performing, how it may be improved, and the degree to which it helps identify and address major risks for fraud, waste, abuse and mismanagement.²

Payroll Operations management utilizes Oracle system generated reports to identify "red flag" transactions as a quality control measure. Reports used include: high – low reports (highest payroll transactions and lowest dollar transaction), checks outstanding, retirement plan mismatching, and any irregular or abnormal appearing data. Any aberrant or outlier transactions are pulled, reviewed and verified by Payroll Operations management. Standard business practices call for a quality assurance plan that includes a periodic regimen of payroll transactions review. This should be done by cycles such as bi-weekly, monthly, quarterly and annually. This would ensure that payroll is continuously monitored for accuracy, completeness and compliance.

Payroll Operations management should monitor trends and practices in the decentralized environment of timekeeping so that additional support and guidance can be provided to affirm accuracy of transactions.

² GAO-O1-1008G, Internal Control Management and Evaluation Tool p. 5

People are what make internal controls work. Management is responsible for an effective internal control system. As part of this responsibility, management sets the entity's objectives, implements controls, and evaluates the internal control system. Management's responsibility includes the design, implementation and operating effectiveness of an entity's internal control system³.

Consequently, we identified a broad range of areas in which management should exercise more obvious responsibility for payroll controls:

- Monitor change tracking log that tracks all changes made to the payroll system, which is useful for tracking down erroneous or fraudulent entries
- Review payments without deductions as there is an enhanced risk that such a payment is to a ghost employee
- Identify simultaneous deposits to the same account
- Run error-checking reports, such as payment activity to terminated employees, net pay exceeds a pre-determined boundary or trigger point, and no payment
- Match garnishment deductions to payables periodically to ensure that deductions are being forwarded in the correct amounts, by the required dates, and remitted to the correct entity
- Maintain and regularly examine a payroll dispute log which is useful for uncovering problems in the payroll system
- Verify roll-forward vacation and sick leave accruals at year-end for employees reaching anniversaries that trigger new rates and for those employees hitting established accrual ceilings

We recognize the extensiveness of the list above. This list represents a collection of successful or best practices recommended for payroll functions for any organization.

As a result of our work and during the course of this audit, management took steps to enhance its quality control measures beyond the regular review of the payroll reports. As noted above this is a more robust quality control plan. This plan, managed by the Treasury Bureau, is structured to support timely payroll processing and disbursement. It will increase the accuracy of recordkeeping, retention of payroll documentation, adherence to federal and state tax withholding obligations and maximize the overall efficiency of payroll operations via the Oracle System. Management has undertaken the City Auditor's recommendations to regularly update this plan to continually improve payroll operations.

³ GAO-14-704G Federal Internal Control Standards p6,p12

IV. Audit Approach and Methodology

The audit approach included looking at key practices in Payroll Operations for effective and essential internal control functions as they apply to areas known to be of risk in payroll transaction processing. Controls tested included policies and procedures, separation of duties, information technology general controls over security, access and physical security, vulnerability to fraud, accuracy in transactions and in the timekeeping system.

In conducting this audit, we:

- Reviewed all applicable written Citywide policies known as Administrative Instructions
- Reviewed Payroll Operations controls, policies, and procedures related to payroll processing and administration
- Interviewed payroll management and staff responsible for administering payroll functions
- Performed walkthrough of payroll transaction processes and physical environment
- Reviewed separation of duties practices and controls
- Randomly sampled and tested payroll transactions for possible control deficiencies
- Reviewed basic information technology general controls over password use, access and physical security
- Reconciled payroll transactions to Human Resource files to validate actual employees of the organization and to validate employee instructions for allowable deductions
- Reviewed desktop procedure manuals for quality control measures

In selecting the 60 samples for process testing, a random number generator was applied to the total population of active and terminated employees in the first four bi-weekly pay periods of FY 2015-16 and 4th quarter Cost of Living verification testing. The selection included a cross section of the population from departments across the City. This selection was used for the entirety of tests conducted during the fieldwork phase of the audit.

V. Statement of Compliance with Government Auditing Standards

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.

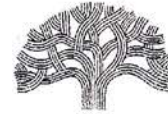


City of Oakland, City Auditor's Office
Summary of Audit Results and Recommendations
September 13, 2016

Observation		Recommendations		Responsible Manager	Management Response	Anticipated Implementation Date
1	Timekeeping authorization controls failed to detect and notify management that an unauthorized employee approved the timecard for their supervisor.	<ul style="list-style-type: none"> The City Auditor recommends a method be developed that when timekeeping authorization changes occur they are flagged and pulled for immediate management review. The City needs to clearly designate Payroll Operations as the central, primary entity to establish the internal control framework responsible for the accuracy, validity, and completeness of payroll transactions. 		Treasurer	Management agrees with recommendation	This recommendation has been implemented
2	Payroll Operations operates under a draft policy titled <i>Administrative Instruction 555: Payroll Procedures</i> and is not yet formalized by Payroll Operations. This AI has not been submitted for review and approval to the City Administrator as required.	<ul style="list-style-type: none"> The City Auditor recommends the Payroll Operations prioritize the revision of <i>Administrative Instruction 555</i> and submit in a timely manner to the City Administrator for review, approval and implementation. 		Payroll Operations Manager; issuance of the AI will be from the City Administrator	Management agrees with recommendation	September 30, 2016
3	City AIs that affect payroll policies or practices are: <ul style="list-style-type: none"> not updated do not describe current payroll practices do not identify an owner to take responsibility for periodically reviewing and updating an AI 	<ul style="list-style-type: none"> The City Auditor recommends a review and update of AIs that affect payroll processes, and adopt the practice of assigning ownership of AIs to those department directors whose work processes most directly impacted by an AI The City clearly designate Payroll Operations as the central, primary entity to establish the internal control framework responsible for the accuracy, validity, and completeness of payroll transactions 		Payroll Operations Manager in coordination with City Administrator	Management agrees with recommendation. Responsibility for AIs 522, 516, 545 and 586 will be assigned by 9/30/16; AI 1016 is obsolete and will be deleted.	January 31, 2017

VI. City Administrator's Response

CITY OF OAKLAND



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September 6, 2016

The Honorable Brenda Roberts
Oakland City Auditor
1 Frank Ogawa Plaza, 4th Floor
Oakland, California 94612

RE: Payroll Audit & Review of Internal Controls

Dear City Auditor Roberts:

I am pleased to provide you with the City's response to the Payroll Audit & Review of Internal Controls report. The City Administration and the Finance Department, which has oversight duties of Payroll Operations, welcome audits to improve efficiency, effectiveness and safeguarding of taxpayer dollars.

Payroll Operations performs a key function within the City by administering over \$570 million in annual compensation to more than 5,000 full and part-time employees. Our employees and our community are dependent upon trouble-free operations of this vital City function.

Due to the audit, the Treasury Division has recently strengthened payroll internal controls so that changes made for timekeeping authorizations are escalated for management review.

Further enhancements to internal controls for payroll timekeeping are as follows:

- Administrative Instruction 555 will be revised to reflect current processes in the Payroll Operations, and
- Payroll Operations will be designated as the central and primary entity to establish the internal control framework for the accuracy, validity and completeness of payroll transactions.

Additionally, other Administrative Instructions, as noted in the audit report will be reviewed and required changes will be made so that these directives are current and up-to-date. My Office will coordinate these updates. The timing for completion of these actions plans are noted in the Summary of Audit Results and Recommendations in the audit report.



Re: Payroll Audit & Review of Internal Controls
September 6, 2016
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I look forward to working with you in continuing to target key areas that could result in additional way to improve accountability and transparency of City resources.

Sincerely,

A handwritten signature in black ink, appearing to be 'Sabrina B. Landreth', written over a horizontal line.

Sabrina B. Landreth
CITY ADMINISTRATOR

Cc: Katano Kasaine, City Treasurer, Financial Services
Sharon Holman, Payroll Operations Manager