



AUDIT MEMORANDUM

January 31, 2006

TO: Stockton City Council

FROM: F. Michael Taylor, City Auditor
Jim Henthorn, Senior Deputy City Auditor

SUBJECT: PAYROLL – FINAL PAYOUT TRANSACTIONS

In accordance with our 2004-05 audit plan, we are conducting an audit of City payroll processing. During preliminary work, transactions came to our attention that prompted further review, the results of which are included in this report. We are continuing our audit of payroll processing, and will report the results in a separate report when that work is completed.

Based on the results of testing, we conclude that a significant internal control weakness resulted in the processing of payroll transactions without adequate supporting documentation. In addition, we noted compliance issues related to payroll tax reporting requirements, and calculation errors resulting in overpayments to employees. These transactions relate to payments for employees separating from City employment.

We are presenting this information as a separate report for two reasons. First, though the initial scope of our work did not include termination payments, once the issues were identified we expanded our scope to include them. Second, since these transactions do not reflect typical City payroll processing, we felt reporting these issues separately was appropriate.

BACKGROUND

During reliability testing of computer-processed data extracted from the City's payroll system, we observed a number of high dollar transactions. These transactions were final payments to employees separating from City employment. In accordance with employee bargaining unit agreements, employees are paid 100% of accrued annual leave, and up to 50% of unused sick leave at separation, with some restrictions. The remaining 50% of unused sick leave is reported to CalPERS (PERS) and converted to Service Credit, which impacts the employee's monthly retirement payment.

In reviewing transaction detail, we noted instances where a small number of employees were paid more than 50% of accrued sick leave. Though the transactions exceeded the monetary threshold requiring Council approval, there was no documentation identifying authority for the transactions. City staff referred only to direction from management as the justification for making the payments. Based on our preliminary observations, we believed this to be a potentially significant control weakness.

There are functions within an organization that are generally considered to be critical control points for the safeguarding of assets. Payroll is one of those functions, performing tasks with established guidelines and authority. It is reasonable to expect that there will be exceptions - situations that are outside the boundaries of normal processing. Even when these exceptional situations occur, staff performing these tasks should expect to receive sufficient information to assess the appropriateness of the transaction. Processing transactions without adequate supporting documentation, based solely on administrative direction, could indicate that a critical control point was circumvented.

SCOPE AND OBJECTIVES

The scope of our audit of payroll included transactions processed during the period January 1, 2004 through June 30, 2005. Based on our preliminary observations, the time period was expanded to July 1, 2000. We focused testing on final payout transactions for terminating City employees.

The objective of our work was to determine if final payout transactions were adequately supported, correctly calculated and paid, and that the City complied with tax authority reporting requirements.

METHODOLOGY

Our procedures included reviewing documentation related to guidance from tax authorities, employee bargaining unit agreements, and City Council actions. We examined selected payroll transactions and supporting detail. We made inquiries of staff from the City Manager, City Attorney, Administrative Services, and Human Resources Departments. We also consulted with outside experts in employee benefit law. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards.

AUDIT RESULTS

Based on our audit, we concluded that internal control weaknesses resulted in sick leave payout transactions being processed without adequate supporting documentation, noncompliance with tax authority reporting requirements, and incorrect sick leave payout calculations, as detailed below:

FINDING: Payroll Transactions Processed Without Adequate Support

Payroll transactions were processed without adequate supporting documentation due to a significant weakness in the City's system of internal controls. When presented with transactions clearly outside normal processing parameters, Payroll staff referred only to direction from management as the basis for making the payments. It was evident from discussions with staff that they believed sufficient documentation had not been provided to support the authority for the transactions, yet the payments were processed.

We noted seven employees who received more than 50% sick leave payout at separation. Six employees received 100% of unused sick leave, and the seventh employee received 500 hours in excess of the 50% threshold. Employee bargaining unit agreements, which are authorized by the City Council, state that upon separation employees will be paid 50% of unused sick leave at its current value. In one instance, a Council Resolution authorized the payment of 100% of unused sick leave to a specific employee. In the remaining six instances, each payout exceeded the dollar threshold requiring Council approval and authority for the transactions was undocumented.

Our initial inquiries of City Attorney, Administrative Services, and Human Resources Department staff identified no clear authority for the transactions. The City Manager's Office conducted additional research and identified a Council action taken January 15, 2002, granting authority to the City Manager.

The January 15, 2002 City Council agenda item 6.3 addressed two items requiring action by the Council. The first item was a short-term amendment to the PERS contract that allowed the City to give two additional years of PERS service credit to employees for retirement purposes. The benefit provides an incentive for employees to retire as a means of reducing the workforce during times of financial hardship or impending layoffs. The second item was a resolution "...authorizing the City Manager to make full payment of accrued sick leave in lieu of additional years of service credit for retirement purposes." However, due to a clerical error the Council Resolution authorizing the City Manager to pay 100% of unused sick leave was not signed or dated. The City Attorney and City Clerk have since corrected this error.

After reviewing all applicable documentation from the January 15, 2002 Council meeting, including the agenda, annotated agenda, staff report and minutes, the City Attorney concluded that Council intended to grant the City Manager the authority to make these payments.

Of greatest concern is the internal control weakness that would allow payroll transactions, or any City transaction, to occur prior to obtaining sufficient information to assess whether the transaction was appropriate. The documentation provided to Payroll did not mention the Council action as the authority for the transactions, and staff did not persist in questioning what was perceived to be a lack of authority.

Management's Action Plan:

The City Manager's Office, Administrative Services and Human Resources will review its processes and incorporate procedures to ensure that Payroll is provided all of the information pertinent to the calculation of all separation-related payouts. This includes documentation of authority for the implementation of any terms outside of normal processing and language from separation agreements that is relevant to the pay calculations. Corrective action will be completed by March 1, 2006.

FINDING: Separation Pay Deferrals are not in Compliance with Tax Reporting Requirements

The City has structured separation payments for five employees to be paid over multiple tax years. Payments were scheduled to span as many as four tax years. The last scheduled payment was made January 2006. Internal Revenue Code § 1.451-2, states that income is constructively received, and must be reported in the tax year during which it is made available without restrictions. The City should have reported the total of all installment payments as income of the employee in the year of termination.

Payroll staff indicated that the only reference to the City scheduling multi-year payouts is in the Fire Unit Memorandum of Understanding, Section 13.18 – Severance Pay Deferral, which states "...Employees eligible for sick leave payoff at retirement may request not to receive that payoff until the first pay period of the calendar year following the date of retirement... To the extent consistent with current tax laws..."

An outside law firm specializing in employee benefit law concluded that, "...the position that the installment payments should not be subject to constructive receipt is defensible, given the dates when these leave payouts first became payable..." They further concluded that recent guidance published by the IRS clarified the tax authority's position, and any future separation payment deferrals would appear to be immediately taxable under current IRS Regulation section 457.

Management's Action Plan:

Management has consulted on this issue with a tax advisor retained by the City. The advisor's observations with respect to the past structured separation payouts support the City's reporting to the IRS on these transactions. The advisor has recommended that the City review its procedures and documentation with respect to the structure of future payments, in light of the most recent IRS guidance.

The City has sought clarification from the advisor regarding acceptable conditions for and reporting requirements of future structured separation payouts. Management will suspend its practice of structuring separation-related payments until a new process is developed that follows the guidelines recommended consistent with IRS regulations. Corrective action will be taken immediately.

FINDING: Sick Leave Payouts Calculated and Paid at the Incorrect Hourly Rate

In reviewing the selected payout transactions, we noted three instances where the hourly rate used to calculate the payment was incorrect, resulting in \$11,902.48 in overpayments to the employees.

In one instance, the use of the incorrect rate appeared to be a clerical error. In the remaining two cases, agreements specifying the terms of the payouts were not provided to Payroll staff, or staff was not aware that the documents contained terms different from the usual calculation process.

Management's Action Plan:

Payroll staff will recalculate the sick leave payouts for the three identified employees, and the City will pursue recovery of any overpayments.

The City Manager's Office, Administrative Services and Human Resources will review its processes and incorporate procedures to ensure that Payroll is provided all of the information pertinent to the calculation of all separation-related payouts. This includes documentation of authority for the implementation of any terms outside of normal processing and language from separation agreements that is relevant to the pay calculations. Corrective action will be taken by March 1, 2006.

OTHER COMMENTS

We would like to commend the Human Resources Department for taking prompt action to address an error identified during testing. In one instance, an employee was paid for 100% of unused sick leave, and 50% of unused sick leave was converted to PERS service credit. This issue appeared to be a clerical error, and corrective action has been taken.

The audit findings described in this report illustrate conditions that potentially exist City-wide. The City of Stockton does not have an employee code of ethics or code of conduct. Employees do not have access to a dissent channel to voice concerns when directed to conduct City business in a manner they perceive to be in conflict with applicable laws, regulations, or policy. A dissent channel is often a component of a larger program to promote an organization-wide ethics policy, which includes ethics training for employees. During our presentation of this report to the Audit Committee, we will initiate a discussion related to these control environment weaknesses.

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