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OFFICE OF THE CITY AUDITOR Audit Report

SYSTEM EVALUATION: CITY PAYROLL PROCESSING

July 2006



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CITY OF STOCKTON

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Stockton City Council

AUDIT SUMMARY: SYSTEM EVALUATION - CITY PAYROLL PROCESSING

In accordance with our 2005-2006 audit plan, we have completed our audit of City payroll processing.

Our audit objectives were to determine whether internal controls over the City's payroll process were adequate, and to assess compliance with applicable statutes and City policies. We conclude that in general, City payroll has been correctly calculated and paid, in compliance with applicable statutes and City policies. However, we did observe areas where internal control improvements could reduce the risk of inadvertent errors, fraud, waste, and abuse.

Opportunities for internal control improvements included: development of policies and procedures, system access controls, quality control activities, compliance with City policies related to time sheets, and the performance of classification reviews to support compensation adjustments.

We commend management for taking a proactive approach to correcting issues identified during the course of the audit. We appreciate the cooperation and assistance extended by management and staff during this audit. Additional information is presented in the Audit Report.

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SYSTEM EVALUATION: CITY PAYROLL PROCESSING

In accordance with our 2005-2006 audit plan, we have completed an audit of City payroll processing.

BACKGROUND

As with many local government organizations, payroll is the City's largest expenditure. For the calendar year 2005, the City reported total wages and other compensation of more than \$110 million. Every employee of the City has some degree of responsibility to ensure that hours worked are accurately reported, and that payroll is correctly calculated and paid.

In 1991, the City adopted the computer software application HTE as its core financial management system. The Payroll/Personnel module (Payroll module) is one of nine HTE modules implemented. Responsibility for the Payroll module is divided among the Administrative Services Department Information Technology Division, and the two module owners, Human Resources Department and Administrative Services Department Payroll Unit. Each City department has a payroll clerk tasked with entering time sheet data for the department's employees into the Payroll module.

Time is entered into the Payroll module on an exception basis. For full time employees, data is not entered for hours worked, but rather for exceptions to the employee's full time schedule, such as leave time taken, or for overtime hours worked. Actual hours worked are entered for part-time employees. The source document for time entry is the employee's time sheet.

The City operates under a semi-monthly pay period system. The first pay period is from the 1st day of the month through the 15th day of the month. The second pay period is from the 16th day of the month through the last day of the month. This creates an unequal number of hours worked in each pay period that must be adjusted, resulting in essentially equal payments for each pay period.

City management has identified automating time sheet data entry at the department level as a future information technology project. To date, no vendor has been found that can accommodate the complexities of the City's payroll system. Though there are several complicating factors, implementation of the City's employee bargaining unit agreements are a primary hindrance. As an example, City Fire Department payroll cannot be calculated by the Payroll module. Instead, Fire payroll is calculated using an Access database program, and then uploaded to the Payroll module for payment.

In November 1998, the City's Payroll Users Group issued a report outlining their observations and recommendations for improvements, but many of the Group's recommendations were not implemented. There has been relatively recent turnover of staff involved in the payroll process, and this has brought a greater appreciation and understanding of internal control concepts.

OBJECTIVES AND SCOPE

The objective of our audit was to determine whether internal controls over the City's payroll process were adequate and functioning as intended. In addition, we wanted to assess compliance with applicable statutes and City policies. Where exceptions were observed, we worked to identify the cause, and to assess the impact.

The scope of our audit took a broad view of City payroll processing. The areas we reviewed included updates and changes to the annual salary schedule, new employee setup, time sheet data entry, payroll calculation and distribution, timeliness of payroll tax payments, and employee income reporting. Payroll testing focused on transactions processed during the period January 1, 2004 through March 31, 2006.

Specifically excluded from the scope of this audit was payroll processing, prior to uploading the data to the Payroll module, performed by the Fire Department. In addition, we did not review processing related to an employee's separation from City service.

METHODOLOGY

To gain an understanding of City payroll processing, we reviewed available documentation including applicable statutes, City policies and procedures, employee bargaining unit agreements, and reports issued by our office and the Payroll Users Group. We interviewed payroll clerks at selected departments, and staff involved with the payroll process in the Human Resources and Administrative Services Departments. We observed payroll activities related to daily operations. We assessed the reliability of computer processed data, and based on auditor judgment selected transactions for testing. We compared what was observed during transaction testing with the applicable criteria for the purpose of assessing compliance. Where weaknesses in internal controls were observed, we communicated them to management with our recommendations for improvement.

During preliminary work related to this audit, we identified what we concluded to be significant control issues. Since these issues were outside the stated scope of our work, we issued a separate interim report in January 2006, entitled Payroll - Final Payout Transactions, to communicate our conclusions. We have also issued suggestion memorandums to management addressing operating conditions that were not in the category of an audit finding, but may represent an opportunity to enhance current operating procedures. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards.

RESULTS

Based on the results of our work, we conclude that in general, City payroll has been correctly calculated and paid, in compliance with applicable statutes and City policies. During testing, we did note occasional errors, but nothing of a significant nature based on the volume of activity processed. Though audit testing did not identify a high error rate in payroll processing, we did observe a number of areas where internal control improvements could reduce the risk of inadvertent errors, fraud, waste, and abuse.

FINDING: Citywide Policies and Procedures

Though there are payroll related Administrative Directives, the City does not maintain comprehensive, written, citywide policies and procedures related to payroll processing. The responsibility for complete and accurate payroll extends to every City employee, in every department. In the absence of citywide guidance, the City is missing an opportunity to promote uniformity in processing, and to emphasize critical roles and activities of the internal control structure. In addition, policies and procedures could formalize segregation of duties by describing the responsibilities of each participant in the payroll process, while listing incompatible activities for each.

To be effective, employees in critical positions should receive training to ensure they understand the policies and procedures, written guidance should be made readily available, and each department's operational processes should be surveyed and monitored to ensure correct implementation.

Management Response:

The Human Resources Department and the Administrative Services Department – Payroll Unit will collaboratively review the segregation of duties between the departments to insure that proper internal controls are in place to safeguard the assets of the City of Stockton. Written policies and procedures will be developed that clearly define the division of responsibilities. The Human Resources Department and the Administrative Services Department – Payroll Unit will develop a meeting schedule to develop these documents.

In addition, both departments will review the payroll processes in each department and develop consistent procedures for the user departments. To develop uniformity, training will be conducted for the payroll users in each department. A first training on the proper use of the Payroll system will be conducted by HTE in July, 2006.

Target Date for Corrective Action: June 30, 2007

FINDING: Computer Access Controls Need Improvement

The City relies on computer application controls to secure confidential data and to limit who has the ability to generate payroll transactions. We noted a number of areas where application controls related to system access could be improved.

Payroll is the only module in the City's financial management system that has two owners, Human Resources and Administrative Services Payroll Unit. This dual ownership makes coordinating issues of internal control more complex and requires specific attention.

There are no written policies and procedures describing the level of system access required for each function. Recently, the City changed the way system access is administered for all HTE modules, granting access to "user groups" with similar data access needs, rather than to individuals. The rationale for the level of access granted to each of the "user groups" established has not been formalized in writing.

The Payroll module owners are to authorize who is granted access to the system, and assess whether the level of access granted is appropriate for the function to be performed. However, the Payroll module owners are not always notified when system access changes are processed by the Information Technology Division. In addition, when employees are assigned to an established user group, the determination as to the appropriateness of the assignment is made by the requesting department, and not by the module owners.

Management Response:

Recognizing the importance of privacy and the increased concern over identity theft, the Human Resources Department in collaboration with the City Attorney and the Administrative Services Department – Payroll Unit and the Information Technology (IT) Division will develop written policies and procedures for the granting of access and the level of access required to the Payroll Module. This access will be based specifically on assigned job duties. The Human Resources Department will also audit current users to determine appropriate access assignment. A committee will be formed comprised of staff from the Human Resources Department and the Administrative Services Department – Payroll Unit and the IT Division to meet on a regular basis to develop appropriate criteria.

Target Date for Corrective Action: December 31, 2007

FINDING: Quality Control and Monitoring Activities Need Improvement

We noted few controls in place to prevent errors from occurring, or to detect errors after they have occurred. A second employee does not consistently verify the accuracy of changes to Payroll module tables, data entry, or the results of manual calculations. After payroll is processed, beyond scanning transaction reports for large or obvious errors, very little is done to ensure that errors have not occurred.

Management Response:

We agree that ideal controls are not in place and recognize there is no substitute for a complete one on one review by another employee. However, staffing limitations and time constraints prohibit this from occurring. Currently 3 ½ full time employees prepare a semi-monthly payroll, and related reports, for over 2,200 employees. Special reports have been designed to assist in the detection of errors. Although we realize that all errors inherently may not be detected, when an error is detected, corrective action is always taken to avoid potential loss to the City of Stockton.

To further strengthen controls, the Human Resources Department and the Administrative Services Department – Payroll Unit will collaboratively create processes to address manual calculations, changes to Payroll module tables, or data entry requiring verification or edits by a second employee. Written policies and procedures will be developed to further document how to complete the process as well as how to correct errors when identified and notification to affected parties (employee, department head and/or departmental payroll clerks). Monthly meetings will be scheduled with the Human Resources Department and the Administrative Services Department – Payroll Unit to develop policies and procedures for guidance on how to identify errors, correct errors and notify affected parties.

Target Date for Corrective Action: July 31, 2007

FINDING: Non-Compliance with City Policy Related to Time Sheets

City policy identifies time sheets as the official source document and audit trail for payroll. Time sheets are to be signed by the employee and supervisor affirming that the hours reported are true, correct, and accurate. In practice, time sheets do not represent a complete audit trail for payroll, and are not consistently signed by employees.

For one department, due to the high number of overtime classification codes used, overtime hours worked are not included on the time sheet. The department has created a form to document each incident of overtime that is used for data entry into the Payroll module, but the forms are not submitted to the Payroll Unit.

For a second department, aside from administrative staff, most employees do not sign their time sheets. The department payroll clerk prepares the time sheets based on daily shift records, but time sheets are not routed to outlying work locations for employee signature. The department payroll person signs all timesheets as the reviewer.

Management Response:

Automated time entry is the desired method of tracking and archival of payroll attendance and will continue to be explored as part of the city wide Electronic Document Management System (EDMS) project. In the short term, FIN-004 will be reviewed and revised as needed. In addition, the necessity for accurate, timely filing of an employees' time sheet will be reaffirmed and communicated by the City Manager to all departments. Departments will be required to submit to Payroll documents and procedures that are a variation to the current official record for acceptance and filing.

Target Date for Corrective Action: January 31, 2007

FINDING: Salary Changes Not Supported by a Classification Review

Changes were made to the Salary Schedule approved by the City Council that were not evidenced by a classification review. Each year since the 2002 – 2003 budget, the Council Resolution related to the Annual Budget has authorized the following administrative action:

“Authorize the City Manager to make salary adjustments in classifications to ensure comparability with similar classifications, as determined by a classification review...”

Classification reviews were typically performed by the Human Resources Department. The results of the review, including any recommendations, are then communicated to the City Manager's office for any action. We noted two instances, related to Management Unrepresented employees, where the only documentation observed to support the salary increase was a memo from the City Manager to the Human Resources Department. Changing salaries without a systematic review can cause imbalances in a compensation system, or risk appearing arbitrary.

Management Response:

The City Manager's Office will ensure that any future salary changes related to adjustments in classifications are coordinated with Human Resources, in order that a systematic review can be performed and the changes substantiated and documented.

Target Date for Corrective Action: Immediate – June, 2006

OTHER COMMENTS

We commend the Administrative Services Department for taking action to protect confidential employee information. During the audit, we commented that employee information was not adequately secured during payroll distribution, an issue that had been raised in the past. Starting with payroll for the period ending June 15, 2006, the City began using checks and direct deposit advices that are printed by a laser printer and sealed, with only the employee's name displayed.

We thank staff of the Administrative Services and Human Resources Departments, and payroll users for the departments visited for their assistance and cooperation.

CITY AUDITOR MISSION STATEMENT

The Office of the City Auditor independently promotes ethical, efficient and effective governance for the citizens of Stockton. We provide the City Council, management, and employees with objective analyses, appraisals, and recommendations for improvements to City systems and activities. The department maintains independence and objectivity by reporting directly to the City Council and by not exercising direct authority over any department, system, or activity subject to audit.

