

REVIEW OF THE SYSTEM OF INTERNAL CONTROL



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Introduction

In accordance with the Financial Integrity and State Manager's Accountability (FISMA) Act of 1983, the Employment Development Department (EDD) submits this report on the review of its system of control for the biennial period ended December 31, 2013.

Under FISMA, the EDD Director is responsible for establishing and maintaining a system or systems of internal accounting and administrative control within EDD. In turn, EDD management is responsible for establishing, maintaining, and evaluating adequate internal controls.

This report is prepared within the format provided by the Department of Finance, Office of State Audits and Evaluations. Should you have any questions, please contact:

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Background

The EDD is a department within the California Labor and Workforce Development Agency. The EDD's mission is to enhance California's economic growth and prosperity by collaboratively delivering valuable and innovative services to meet the evolving needs of employers, workers, and job seekers.

The EDD is one of the most recognized State departments in California providing a variety of services to businesses, workers, and job seekers. The EDD:

- Administers several multi-billion-dollar benefit programs including the Unemployment Insurance (UI), Disability Insurance (DI), and Paid Family Leave programs that provide financial stability to workers and communities.
- Administers, through partnerships at the local level, hundreds of millions of dollars in federal Workforce Investment Act (WIA) funds used to provide employment and training services to adults, youth, and dislocated workers.
- Administers the employment service programs providing critical services to workers, job seekers, and the veteran community.
- Collects more than \$52 billion in payroll taxes annually from nearly 1.4 million registered employers.
- Collects California's labor market information and employment data that is critical for making policy decisions at the state, regional, and local levels.

- Maintains a workforce of more than 9,000 dedicated public servants working in more than 220 locations providing critical services to California citizens.
- Maintains one of the largest information technology environments in California State government.

The EDD's strategic plan, "One Vision, One Team - EDD," includes five strategic goals:

GOAL I: Fiscal Stewardship

Responsibly manage our public resources and align investments with strategic goals.

GOAL II: Skilled Workforce

Build a highly skilled and responsive workforce with clear roles and responsibilities.

GOAL III: Sustainable Operations

Align system operations, administration, resources, and business processes with strategic priorities and budgetary parameters.

GOAL IV: Enabling Innovation

Invest in our future by supporting appropriate business and technology solutions.

GOAL V: Responsible Service

Negotiate clear commitments with stakeholders and focus on priorities.

Vacant Positions As statutorily required, EDD is in compliance with Government Code (GC), Section 12439. Our compliance includes working with the Department of Finance to eliminate unneeded vacant positions from the EDD budget. In addition, EDD has established guidelines for managing vacant positions consistent with Assembly Bill 3000 (Chapter 1124, Statutes of 2002) which amended GC, Section 12439.

Risk Assessment

The Department of Finance specifically requires that each department's FISMA report addresses the approach taken to perform an organization-wide risk assessment and includes the results of that assessment.

In 2013, the EDD Executive Leadership Team (ELT) completed a departmental risk assessment that identified three enterprise-level risks in three strategic areas. These risks could impact EDD's achievement of its strategic goals and critical business objectives. The risks identified are:

Risk#1: Fiscal Stewardship

Not obtaining adequate federal or state administrative funding, coupled with the challenges of a large department's need to rapidly reduce operating expenses, threatens our ability to properly operate our programs.

Risk#2: Skilled Workforce

Not maintaining an adequately trained workforce to carry out our mission of delivering valuable and innovative services to meet the evolving need of employers, workers and job seekers.

Risk#3: Responsible Service

Not effectively driving our customers to more efficient self-service options in order to meet their needs.

To complete this risk assessment, the ELT held several meetings to identify, refine, and ultimately finalize the most critical risks facing EDD. The ELT then identified additional controls to mitigate those risks.

Working from the EDD's 2012-2016 Strategic Plan, potential risks impacting each strategic goal were identified and presented to the ELT. The ELT reviewed the potential risks identified and assessed their relative ranking based on impact to the organization, probability of occurrence, and the amount of risk EDD is willing to accept to meet its business objectives. The ELT then clarified and finalized three risk statements which reflected EDD's most critical risks. Risk owners within EDD were also identified at this stage in the process. The last step in the enterprise risk assessment process involved the ELT assessing the adequacy of existing controls for each critical risk and, where needed, identifying new controls to mitigate each risk to an acceptable level.

Evaluation of Risks and Controls

As described previously, the ELT identified the three most critical risks facing EDD and the associated controls needed to mitigate those risks to an acceptable level. The ELT determined that EDD had existing controls in place and operating to effectively manage these risks. However, the ELT decided that EDD could further mitigate these risks by implementing additional controls. The three most critical risks and corrective action plans for implementing the additional controls are listed below.

Risk#1: Fiscal Stewardship

Not obtaining adequate federal or state administrative funding, coupled with the challenges of a large department's need to rapidly reduce operating expenses, threatens our ability to properly operate our programs.

While maintaining existing controls to address this risk, EDD will implement additional controls by June 2015 including the following:

- Conduct strategic resource planning to achieve affordability.
- Advocate for appropriate levels of federal and state funding.
- Pursue business process re-engineering for greater operational efficiencies.

Risk#2: Skilled Workforce

Not maintaining an adequately trained workforce to carry out our mission of delivering valuable and innovative services to meet the evolving need of employers, workers and job seekers.

While maintaining existing controls to address this risk, EDD will implement additional controls by June 2015 including the following:

- Improve employee awareness of EDD's operations, business environment and career development opportunities.
- Identify skill gaps for mission critical priorities and deliver targeted training.

Risk#3: Responsible Service

Not effectively driving our customers to more efficient self-service options in order to meet their needs.

While maintaining existing controls to address this risk, EDD will implement additional controls by June 2015 including the following:

- Develop strategies for increasing customer utilization of self-service options.
- Promote our self-service options to stakeholders.

Other Control-Related Actions

The EDD takes multiple actions to ensure it has a strong system of control over its programs and operations consistent with the model promulgated by the Committee of Sponsoring Organizations (COSO). COSO defined internal control as a process that is affected by EDD's employees, including management and other personnel. This process is designed to provide reasonable assurance that EDD achieves its objectives of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. These objectives and the COSO model are consistent with FISMA requirements.

The COSO model identifies five essential components of a strong system of control. The EDD effectively addresses each of these components in its system of control:

Control Environment – The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by those in governance.

Risk Assessment – Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is the establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory, and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Control Activities – Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

Information and Communication – Pertinent information must be identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports related to operational, financial, and compliance information that make it possible to run and control the business. Personnel deal not only with internally generated data, but also information about external events, activities, and conditions necessary to ensure informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across, and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties such as customers, suppliers, regulators, and other stakeholders.

Monitoring – Internal control systems need to be monitored--a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and those in governance.

Following are highlights of some control-related actions EDD performs to ensure it maintains a strong system of control over its programs and operations:

Branch Program Controls

The EDD maintains critical controls that help ensure program objectives are achieved, operations are efficient, and applicable laws and regulations are adhered to. The following are examples related to programs administered by EDD:

DI Branch Program Controls – The EDD DI Branch audits State Disability Insurance (SDI) claims and warrants on a quarterly basis using a statistically valid random sample of processed claims. These audits verify that claimants meet the essential eligibility requirements and that eligible claimants have been paid accurately. The results of

these audits are also shared with DI Branch senior management to help identify potential process improvement areas.

The DI Branch also ensures that benefits are paid only to eligible claimants and internal business processes are operating to protect, detect, and deter internal and external fraud and abuse. Additionally, numerous automated program integrity business rules have been developed to assist in the detection of potential fraud and abuse. Lastly, the DI Branch works closely with EDD's Investigation Division to safeguard the SDI fund.

Tax Branch Program Controls – The EDD Tax Branch audits and investigates business entities that employ California workers to determine if they are in compliance with the California UI Code requirements for reporting their employees' wages and remitting UI and Employment Training Tax contributions, and SDI and California Personal Income Tax withholdings to EDD. These audits verify whether the employer's payroll posting system and acknowledged payroll are correct. These audits also identify misclassified workers and unreported wages. Additionally, the Tax Branch conducts investigations to detect and deter employment tax violations in the underground economy.

Another critical control function performed by the Tax Branch is the cashiering of all remittances received from employers and claimants. Tax Branch staff follow internal procedures and policies to ensure the financial integrity of all remittances received, processed, and deposited. Approximately 74 percent of remittances received are electronically "deposited" directly into EDD's bank account; a portion of these remittances are deposited via wire transfer. The remaining 26 percent of the remittances are received by paper (through the mail and in person) and are sorted, opened, batched, scanned, and prepared for deposit using high-speed automated mail sorting and opening equipment. Information for each remittance is imaged, data is captured by the remittance application which tracks the day's receipts, balances the batches, and tallies the total of the remittances. All monies deposited, including electronic payments, are reported to the State Treasurer.

UI Branch Program Controls – The EDD UI Branch performs daily and quarterly audits of UI benefits. These audits help ensure the integrity of the UI program by identifying claimants who may be working while drawing unemployment benefits inappropriately or fraudulently. The goals of these audits are to obtain accurate work/earnings and eligibility information and to prevent employers from being subject to higher tax rates based on incorrect information.

The UI Branch conducts the daily benefit audit by performing a cross match of New Employee Registry data with UI claims to determine if a claimant has received benefits after returning to work. The quarterly benefit audit is conducted by performing a cross match of wage information reported by employers with the claimant's UI benefit information in the same quarter. When a match is identified, EDD requests that the employer verify information about the individual, their wages, and eligibility. If a potential violation occurred, a Notice of Potential Overpayment is sent to the claimant. Overpayments and penalties are established and collected to help protect the solvency of the UI Trust Fund and help control or reduce employer taxes.

In addition to audits of UI benefits, the UI Branch has taken various measures to ensure the true identity of a claimant for UI benefits and, thereby, detect and deter fraud. Implementation of the Identity Alert Process enables the UI Branch to protect the worker and employer from ongoing fraud and ensure the proper payment of UI benefits. When a claim is initiated into the Identity Alert Process, no payments are issued until EDD obtains the information needed to validate the identity of the individual filing the UI claim. Upon receipt of required documents from claimants, the information is validated against records from EDD, the Department of Motor Vehicles, and the Social Security Administration.

Workforce Services (WS) Branch Program Controls – The EDD WS Branch oversees the administration of the federally funded WIA and Wagner-Peyser programs that provide job training assistance to job seekers and help employers find qualified workers. To accomplish this goal, the WS Branch enters into contracts with Local Workforce Investment Areas (LWIA) and non-government entities receiving federal funds. The WS Branch utilizes the Job Training Automation System to monitor contract compliance and expenditures of grant recipients. The WS Branch reviews requests from grant recipients for funds and approves or denies cash requests in accordance with federal regulations and State guidelines.

The WS Branch provides consultation to California's LWIA administrators and their One-Stop Career Center partners to promote the development and operation of an effective and efficient workforce investment system. The WS Branch provides technical assistance to LWIAs to help resolve findings or issues resulting from on-site monitoring or reviews performed by the EDD's Compliance Review Office, the Department of Labor, other oversight agencies, or single audits. In addition, the WS Branch conducts "fact-finding" on behalf

of EDD when a report concerning fraud and/or abuse is filed against a local area entity.

Internal Control Self-Assessments

To ensure a strong system of program and operational controls, EDD executes an internal control self-assessment process across the Department. This process was designed to evaluate the effectiveness and efficiency of operations including the achievement of strategic goals and compliance with laws and regulations.

The self-assessment tool takes the form of a checklist comprised of a series of key questions on whether specific internal controls are in place and whether actions are planned to correct any deficiencies found. The checklist is revised on a continuous basis to ensure that EDD adapts to changes in the business environment. The checklist currently distributed to all EDD branches covers important areas of EDD's programs and operations.

The self-assessment process provides valuable information on the adequacy of key internal controls throughout EDD. Upon completion of the self-assessment checklist by each branch, the results are reported to the Chief of EDD's Audit and Evaluation Division (A&ED). The A&ED then independently validates the results and corrective actions planned and taken as part of fulfilling its internal audit responsibilities.

Internal Audits - Compliance and Control Segment Audits

The A&ED serves as EDD's internal auditor and provides independent and objective audits, evaluations, technical assistance, surveys, consultation, and other services throughout EDD. This internal audit function further strengthens EDD's internal controls as a part of the COSO monitoring component of internal control.

The A&ED conducts compliance audits to assess whether EDD has complied with rules, regulations, and requirements related to various business and program operations. Compliance encompasses the variety of rules, regulations, and requirements that EDD must follow in carrying out its operations and programs.

The A&ED also conducts control segment audits as part of its internal audit responsibilities. These audits are designed to look at internal controls within a specific business function or process and improve the efficiency or effectiveness of operating function to satisfy the expected business results.

For the current biennial review period, A&ED audited numerous activities and processes such as destruction of confidential records, information technology expenditures, direct charges of rental vehicles, departmental vehicle usage, employee separations, and EDD's procurement process.

Because EDD's business activities are so diverse and expansive, the A&ED has developed an inventory of possible projects to aggregate the various components of EDD's operations, programs, policies, and responsibilities into a manageable tool to support A&ED's audit responsibilities. Below are two of A&ED's internal audit projects completed for biennial year 2012-2013:

Destruction of Confidential Records Audit

Records Management is the professional administration of information in the physical or electronic form of records. The life cycle extends from the time records are received or created, through processing and use, to placement in storage and retrieval systems, until eventual elimination or destruction of the records. The EDD Records Management Program is coordinated by the Business Operations Planning and Support Division. The program is designed to provide efficient and economical management of records from origination through retention and disposal.

The A&ED completed its Destruction of Confidential Records Audit to evaluate EDD's compliance with departmental policies and procedures pertaining to the destruction of paper confidential records held at EDD's Central Office. This audit assessed whether EDD is complying with its policies and procedures as included in the Office Management Handbook regarding the destruction of confidential records at the EDD Central Office only.

Employee Leave Balance

The EDD is one of the largest State departments in California with employees receiving annual, sick, and other leave benefits. The Fiscal Programs Division estimated that the EDD spent approximately \$7,767,000 in leave costs monthly for Calendar Year 2011. In all cases, accuracy of employee leave balances is essential to ensure that correct leave benefits are paid to employees to which they are entitled. In addition, accurate recording of leave balances will help avoid unnecessary costs resulting from errors and it ensures compliance with the EDD's policies, procedures, and directives.

The A&ED completed a review of employee leave balances maintained by the Human Resource Services Division and the Attendance Reporting Units to determine if there are significant

differences in employee leave balances between employee records, Attendance Reporting Unit records, and monthly leave system reports.

Electronic Benefit Payment Contract with Bank of America

The EDD has implemented the Electronic Benefit Payment (EBP) system which enables issuing SDI, Paid Family Leave, and UI benefit payments to claimants using an EDD debit card. The EBP project is part of the EDD's continuing automation efforts to provide benefits to eligible claimants more efficiently resulting in nearly all payments being made electronically. Complete elimination of paper warrants will be achieved as part of the project's Maintenance and Operations Plan. The EDD contracts with Bank of America to provide the EDD debit card services. As of June 30, 2013, over 4.2 million cards have been produced and just under \$38 billion has been disbursed to claimants through EDD debit cards.

The move from benefit checks to debit cards extends EDD's system of controls to include those over the administration of the EDD debit card. The EDD's contract with Bank of America includes comprehensive programmatic, fiscal, and operational requirements to ensure strong controls exist over the EBP system and service delivery. The EDD also has initiated departmental audits of the system and services in addition to an annual Service Organization Controls report which address controls related to auditing user financial statements, operations, and compliance.

External Reviews Compliance Review Office

The EDD obtains WIA funds from the federal government and grants them to LWIAs to carry out the WIA program. To provide strong control over this program, the Compliance Review Office conducts annual reviews that assess the LWIAs' operations and fiscal and procurement systems relative to the WIA programs.

The operations portion of these reviews include evaluating the One-Stop delivery system, Workforce Investment Board composition, local-level oversight and monitoring, management information system/reporting, incident reporting, nondiscrimination and equal opportunity, participant eligibility, and WIA activities and services (core, intensive training, and supportive services), along with other aspects of the program.

When reviewing the LWIA fiscal and procurement systems, the Compliance Review Office looks at items such as expenditure reports, cash management, internal controls, cost allocation, cost

sharing at the One-Stop Centers, fiscal and procurement oversight, small purchases, competitive proposals and sole source procurements, contract agreements, and property management.

Conclusion

Based upon the results of its internal review, risk assessments, and results of both internal and external audits, it was determined that EDD's system of control is adequate to ensure that EDD achieves its objectives of reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

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The California State Employment Development Department is a recipient of federal and State funds, is an equal opportunity employer/program, and is in compliance with Section 504 of the Rehabilitation Act and the Americans with Disabilities Act.

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