December 29, 2023

Joe Stephenshaw, Director
California Department of Finance
915 L Street
Sacramento, CA 95814

Dear Director Joe Stephenshaw,

In accordance with the State Leadership Accountability Act (Leadership Accountability), the State Controller submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2023.

Should you have any questions please contact Cathy Leal, Acting Chief Operating Officer, at (916) 720-3089, cleal@sco.ca.gov.

GOVERNANCE

Mission and Strategic Plan

The State Controller Malia M. Cohen, is the chief fiscal officer of California, the fifth largest economy in the world, responsible for accountability and disbursement of the state's financial resources. Controller Cohen also safeguards many types of property until claimed by the rightful owners, independently audits government agencies that spend state funds, and administers the payroll system for state government employees and California State University employees.

Controller Cohen serves on 70 boards and commissions with authority ranging from state public land management to crime victim compensation and is a member of numerous financing authorities, and fiscal and financial oversight entities including the Franchise Tax Board and Board of Equalization. Controller Cohen also serves on the boards of the nation's two largest public pension funds.

The Controller's primary objectives are as follows:

- Account for and control disbursement of all state funds, issuing warrants in payment of the state's bills.
- Determine legality and accuracy of financial claims against the state.
- Audit state and local government programs and agencies.
- Ensure businesses report and remit unclaimed property in compliance with Unclaimed Property Law and safeguard remitted unclaimed property until claimed by the rightful owners or heirs.
- Inform the public of the state's financial condition.
- Inform the public of financial transactions of city, county, and other local governments.
- Administer the Uniform State Payroll System.
- Audit and process all personnel and payroll transactions for state civil service, state

exempt employees, California State University employees, and Judicial Council employees.

The mission and goals of the State Controller's Office (SCO) are as follows:

Mission: The California State Controller's Office ensures the state government's monetary resources are independently accounted for and disbursed according to law in a timely manner.

Goals:

1. Ensure the full implementation of FI$Cal and the associated timely and accurate release of the Annual Comprehensive Financial Report.
2. Launch an Agency-Wide modernization strategy that includes an organization assessment and an intentional path forward with emphasis on the most significant short and long-term investments that will have the greatest impact on our team members and customers.
3. Leverage technology to transform the State of California's Payroll Processing, Disbursements, and Payment Systems.

The California State Controller is one of eight statewide constitutional officials who are elected every four years in California (in some states, this government official is called a Comptroller). The State Controller's team of more than 1,600 public servants is dedicated to efficient accountability and disbursement of California's financial resources. From audits and financial reports to payroll and unclaimed property, SCO employees collaborate to provide essential government services with a focus on quality and integrity.

The major functions of the State Controller's Office (SCO) include the following:

Executive Office

Provides the policy and operational priorities for the State Controller's Office (SCO). SCO functions are coordinated by the Chief of Staff with support from the Chief Operating Officer and the Chief Administrative Officer. The Chief Legal Counsel and Deputy Controllers responsible for legislative affairs, public affairs, external affairs, pension funds/investments, environmental policy, health policy, and taxation policy also advise the Controller. The Executive Office also includes Human Resources, Equal Employment Opportunity, and Management Audit and Review Services (internal audits).

Administration and Disbursements Division

Produces the warrants (checks) and electronic fund transfers from the State Treasury, annually issuing about 49 million payments including state payroll, retirement rolls, Medi-Cal, personal income tax refunds, and payments to vendors. Provides staff support services to SCO including budgeting, accounting, contracting, training, procurement, and facilities management.

Division of Audits

Responsible for auditing all funds disbursed by the state and all claims presented for payment to SCO. Performs independent audits of government agencies that spend state funds. Assures

the accuracy of local government claims and financial statements submitted to the state and federal government by annually reviewing and revising audit guidelines, reviewing audits performed by independent local auditors under these guidelines, and performing field audits of state and federal programs. Assists and advises local government officials in effective and uniform tax collecting procedures and internal fiscal controls. Audits highway users' tax funds at local levels, and the allocation and apportionment of local property taxes.

Information Systems Division

Ensures the integrity and security of SCO technology, employees, and facilities. Supports SCO mainframe, public website, and payroll systems with services including application development, desktop support, and project management oversight.

Local Government Programs and Services Division

Issues payments to local governments and schools. Works with local governments, prescribing budgeting and accounting guidelines for California's 58 counties and more than 4,900 special districts. Allocates funding to local governments and schools for state-mandated costs and apportionment funding. Manages the Property Tax Postponement Program. Refunds gas tax on motor fuel not used on highways. Collects taxes owed to the state and provides property tax and reference manuals for county tax collectors. Approves county cost allocation plans.

Personnel and Payroll Services Division

Processes payroll and leave accounting for all state civil service and exempt employees, state court, and California State University employees. Provides information required to manage the personnel resources of the state and to properly account for salary and wage expenditures. Provides data to the retirement systems necessary for calculation of employee retirement benefits. Manages the state's automated travel expense claim system.

State Accounting and Reporting Division

Performs statewide accounting and reporting functions, issuing reports on the financial condition of government entities. Reports the financial condition of the state on a monthly basis, and publishes the California Annual Comprehensive Financial Report and the Budgetary/Legal Basis Annual Report. Accounts for receipts, payments, balances, and bonded indebtedness of all state funds.

Unclaimed Property Division

Safeguards lost and forgotten property turned over to the state (e.g., bank accounts, uncashed checks, insurance benefits, wages, stocks, bonds, and safe deposit box contents) until claimed by the rightful owners. Operates an online search tool and toll-free telephone service, processes claims, and provides written notices to property owners and property holders.

California State Payroll System Project:

The California State Payroll System (CSPS) Project will modernize the human resource management, travel and business expense, and payroll systems used by approximately

300,000 state government employees in order to provide accurate and timely personnel and payroll service with quality customer service. The CSPS Project is primarily a Human Resource Management project that is designed to take the opportunity to improve the core administrative functions through innovation and improvements.

Control Environment

The State Controller's leadership is committed to responsible governance, integrity, customer service, innovation, and collaboration and these core values are central to our codes of conduct and control environment. Ethical concerns are reported through the Whistleblower hotline that is available on the SCO intranet. The Controller provides oversight of the SCO and the Executive Team manages their program areas to establish an effective control environment.

To ensure the appropriate levels of responsibility and authority, SCO's organizational structure includes the Administration and Disbursements Division, California State Payroll System Project, Division of Audits, Executive Office, Information Systems Division, Local Government Programs and Services Division, Personnel and Payroll Services Division, State Accounting and Reporting Division, and the Unclaimed Property Division. The Executive Office provides the policy and operational priorities for the State Controller's Office (SCO) and its functions are coordinated by the Chief of Staff with support from the Chief Operating Officer and the Chief Administrative Officer. The Chief Legal Counsel and Deputy Controllers responsible for legislative affairs, public affairs, external affairs, pension funds/investments, environmental policy, health policy, and taxation policy also advise the Controller. The Executive Office also includes Human Resources, Equal Employment Opportunity, and Management Audit and Review Services (internal audits).

Each SCO division is responsible to maintain, regularly review, and update their written operational policies and procedures. Management is also expected to lead by example, by conducting day-to-day operations with the highest degrees of integrity and professionalism. Staff roles and responsibilities should also be current and well-defined. Strong lines of authority, control, collaboration, and communication are fostered and expected throughout SCO.

Lastly, SCO has formal written policies that explain appropriate workplace expectations for SCO employees, including policies that cover the following subjects: Conflict of Interest, Sexual Harassment, Drug-Free Workplace, Workplace Violence, and Equal Employment Opportunity. It is also a mandatory requirement that SCO employees attend training courses related to the ethical behavior standards and regulations that govern the official conduct of SCO employees.

Also, vital to maintaining a secure control environment, the SCO Executive Team recruits, develops, and maintains a competent workforce and continuously evaluates its performance while enforcing accountability. The SCO Workforce Plan provides clear and relevant guidance that aligns staffing and competencies with our organization's current and future strategic business needs.

Information and Communication

The State Controller's Office consistently reviews and evaluates the systems of internal controls through ongoing monitoring, documentation, and executive oversight. There are weekly Division Chief meetings for senior and executive management to discuss and document items of significant impact, including current and potential internal risks and control issues. In addition, Deputies, Division Chiefs, and Project Managers regularly meet individually with the Chief of Staff to discuss in greater detail significant issues. The Chief Administrative Officer and Chief Operating Officer (CAO/COO) meet regularly with the Chief of Staff to discuss issues of concern and make recommendations to the State Controller for appropriate mitigation strategies for each issue.

The communication of information is necessary to carry out the internal control responsibilities promoting the achievement of SCO's goals. SCO utilizes duty statements, expectations memorandum for every SCO position along with organizational charts for the entire organization, divisions, bureaus, and programs. Management uses these tools to communicate and reinforce SCO staff roles and responsibilities. Duty statements include description of the areas that managers are responsible to manage and review, including monitoring internal controls, and the essential roles of responsibility to implement and monitor those controls.

Management also uses relevant and quality information from both internal and external sources to support the functioning of internal control systems. SCO management is responsible for developing and maintaining an effective information and communication process to ensure SCO staff clearly understand their internal control roles and responsibilities.

SCO employees also have resources to communicate vulnerabilities and control inefficiencies through the internal units, such as Management Audit and Review Services (MARS). Lastly for employees, the Equal Employment Opportunity (EEO) Office manages the complaint process and conducts investigations.

SCO utilizes various communication tools to engage its external customers, such as annual meetings, monthly reports, emails, memos, phone calls, press releases and use of its public website to convey messages and discuss issues with the citizens of California. The Controller's public website contains hundreds of pages of transparent information about programs, services, audits, and businesses under the Controller's authority. The SCO answers questions, provides information, refers questions to appropriate SCO staff, and provides programs and services to educate and assist the public as needed. Relative to communicating information to external parties, MARS is the designated SCO liaison responsible to communicate with external entities who are tasked to audit operational processes. MARS ensures that accurate, complete, timely, and quality information is communicated to external parties.

MONITORING

The information included here discusses the entity-wide, continuous process to ensure internal control systems are working as intended. The role of the executive monitoring sponsor includes facilitating and verifying that the State Controller monitoring practices are implemented and

functioning. The responsibilities as the executive monitoring sponsor(s) have been given to: Cathy Leal, Acting Chief Operating Officer.

SCO holds regular executive staff management meetings and bimonthly senior management meetings. Topics at such meetings include discussion of current and potential internal control issues that may need to be addressed and what steps are needed to mitigate the issues. These executive management meetings occur while staff continuously monitors SCO programs for issues and corrective actions, and take necessary corrective actions if issues are observed.

The Chief of MARS works with every SCO division to obtain risks for each new SLAA biennial reporting cycle. This process ensures the SCO's SLAA monitoring activities address the most current issues facing the SCO, and new biennial reports accurately reflect SCO's efforts to mitigate new emerging operational risks. SCO publishes SLAA updates for SCO Division Chiefs, SLAA division contacts, and SCO executive management to increase transparency and promotes teamwork between SCO divisions to mitigate risks.

The SLAA monitoring process at each division is the dual responsibility of Division Chiefs and their designated SLAA contacts. SLAA monitoring processes provide input received from divisions, such as policies, procedures, and work flows. Evaluation is ongoing and any preliminary inefficiencies are brought to the attention of Division Chiefs and SLAA division contacts for response and corrective action. Corrective action plans are then monitored on an ongoing basis.

MARS conducts internal audits to ensure that all SCO programs are performing in accordance with State and Federal rules and regulations, to help meet the goals and objectives of the State Controller. Through MARS' ongoing monitoring efforts, internal control deficiencies and opportunities for improvement are presented to division program management and SLAA division contacts for their responses and required Corrective Action Plans (CAPs). MARS monitors the status of CAPs and formally reports the status of corrective actions to SCO Division Chiefs, SLAA division contacts, and SCO executive management. In addition, MARS works with the executive management team to address vulnerabilities by ensuring policies, procedures, standards and/or guidelines are effective. These vulnerabilities are documented and monitored through reports and CAPs. Results are evaluated to ensure appropriate corrective actions are implemented and documented.

MARS staff, who are not directly involved with day-to-day operation of the control system under review, will perform internal periodic detailed reviews to confirm the effectiveness of the internal control systems. A review of strategic objectives and comparison of results to expectations is performed to determine if changes are needed. MARS will work with the executive management team to assign ownership for addressing vulnerabilities identified through monitoring. In addition, risk owners will monitor progress on a regular basis and risk reporting will occur on a quarterly basis to reduce identified vulnerabilities. These monitoring activities are performed, documented, and measured against the strategic goals and objectives. Management will evaluate monitoring results and ensure that CAPs are documented and risk strategies are implemented to reduce vulnerabilities.

RISK ASSESSMENT PROCESS

The following personnel were involved in the State Controller risk assessment process: executive management, middle management, front line management, and staff.

The following methods were used to identify risks: brainstorming meetings, employee engagement surveys, ongoing monitoring activities, audit/review results, other/prior risk assessments, questionnaires, consideration of potential fraud, and performance metrics.

The following criteria were used to rank risks: likelihood of occurrence, potential impact to mission/goals/objectives, timing of potential event, potential impact of remediation efforts, and tolerance level for the type of risk.

The SCO is in the process of implementing an Enterprise Risk Management (ERM) Framework to align with the "Three Lines of Defense" model, as outlined by the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control – Integrated Framework. This framework will better establish and coordinate duties related to risk and control.

As outlined in the COSO, the three lines of defense are as follows:

First Line: Operational Management
Front-line and mid-line managers are the first line of defense and responsible for day-to-day ownership and management over risks and controls. This group owns the risk and executes the controls to enhance the likelihood that the organization's objectives are achieved.

Second Line: Internal Monitoring and Oversight Functions
The second line of defense is a management and oversight function that supports senior management and owns aspects of the risk management process. This level brings together additional expertise and monitoring to the first line to assist risk owners to properly manage and report risks and controls.

Third Line: Internal Audit
The third line provides assurance that the first and second lines of defense are meeting expectations and is performed by Management Audit and Review Services (MARS). A systematic approach is utilized to evaluate and improve the effectiveness of risk management, control, and governance processes. This assurance covers the effectiveness of the first and second lines of defense. Internal audit is performed within MARS to ensure independence and professionalism and that it operates at a high level of independence and objectivity.

As the SCO begins to implement and mature its ERM Framework, MARS will provide regular updates that will be discussed and reviewed with the Controller, Chief of Staff, Chief Counsel, Division Chiefs, and select Bureau Chiefs. This governance structure and process will utilize a risk-based approach to managing risks and integrating concepts of internal control and strategic planning. The ERM Framework will be utilized to conduct an assessment of potential risks and identify mitigation strategies to reduce risks and vulnerabilities to a reasonable and appropriate level. MARS provides auditing, consulting and risk management services to SCO. MARS facilitates the identification and evaluation of risks, evaluating controls, and monitoring mitigation strategy recommendations.

Executive management and middle management work with front line management and staff to identify current and potential risks that are documented and monitored on a semi-annual basis. In 2024, quarterly reporting will mature the ERM process and risk assessments will continue through regular brainstorming discussions, meetings, surveys, questionnaires, ongoing monitoring activities, and audit results among other methods and inputs. A risk scoring methodology has been developed to rank and score risks that includes the likelihood of occurrence, potential impact to mission/goals/objectives and remediation efforts, and the speed of onset that measures how quickly a risk is estimated to occur. Once vulnerabilities are identified and confirmed, they are documented and added to the quarterly review updates. Newly identified significant vulnerabilities are elevated to the Chief of Staff for evaluation and a determination is made to mitigate, monitor, or accept the risk and/or vulnerability.

RISKS AND CONTROLS

Risk: Transferring the Book of Record Functionality from the SCO Legacy System to FI$Cal

SCO continues to face a significant risk that FI$Cal deliverables may not accurately and completely satisfy SCO's business requirements. A staffing shortage has created the risk that the Department of FI$Cal will be unable to provide all necessary support and maintenance functions after the project is officially completed. SCO has limited Subject Matter Expert (SME) staff resources to complete end-to-end FI$Cal design and user acceptance testing. SCO has also had to troubleshoot deployment issues. SCO may not be able to continuously provide necessary fiscal control and reporting functions, due to the strain on our SME's availability.

Control: Increased Participation with FI$Cal Partners

SCO continues its best efforts to increase participation with FI$Cal partners, other FI$Cal agencies, and the vendor to review system designs. SCO also actively participates in FI$Cal testing to help ensure SCO's business needs are met by FI$Cal.

Control: Increased Staff Availability

SCO continues to pledge its best efforts to make SMEs available to assist with the FI$Cal project, depending upon normal SCO operational process needs and workloads.

Control: Continue to Work with Control Agency Partners and Department of FI$Cal

SCO continues to work collaboratively with departments, the Department of Finance (DOF), and project partners to identify and mitigate possible FI$Cal system and security issues. Risk related to timely Annual Comprehensive Financial Report (ACFR) and General Fund and Special Fund reports to DOF due to the State's transition to FI$Cal are identified. A comprehensive plan is under development to remediate the delinquent ACFR timeline within a time span of 3-4 years. In addition, SCO continues its on-going monitoring efforts for mandated SLAA reporting requirements.

Control: Additional Funding

SCO continues its best efforts to secure additional FI$Cal-related funding from DOF and the legislature.

Risk: Key Person Dependency and Succession Planning

Key Person Dependency (KPD) and staff turnover continue to threaten SCO's ability to meet its roles and responsibilities. SCO's workforce continues to age and many staff are nearing retirement. SCO replacement staff may require years of training and experience to become proficient in their roles and responsibilities. SCO management have difficulty recruiting qualified applicants, especially at the higher levels or in areas that require specialized knowledge, skills, and abilities. Pay disparity between SCO and other state agencies may attract SCO staff to obtain better salaries. The resulting loss of critical institutional knowledge and/or shortage of competent staff could adversely affect SCO's ability to meet its roles and responsibilities and/or shortage of competent staff could adversely affect SCO's ability to meet its roles and responsibilities.

Control: Backfill Vacant Positions with Competent Staff

SCO continues to work to backfill vacant positions quickly, increase training and cross-training opportunities, utilize shadow positions, and use retired annuitants, where appropriate, and review its succession plans. In addition, SCO has recently established a New Employee Orientation Committee with participants across the organization to assist with our retention efforts.

Control: Consultation with CalHR

SCO continues to work closely with CalHR on an on-going basis to ensure that the following occurs.

- Job responsibilities are appropriate for current job roles and
- Potentially upgrade certain classifications used by SCO to align with other agencies doing equivalent work, but having higher compensation, in some of its critical roles such as Auditors and Accountants.

Control: Ensure Policies and Procedures are Current

SCO divisions continuously review documented policies and procedures to ensure that roles and responsibilities are thoroughly documented with concise, clear, and understandable terms. If new processes require policy or procedure revisions, they are addressed, documented and implemented using generally accepted change management practices.

Control: Ensure Succession Plans are Current

SCO management continues to review its succession plans to help ensure that current staff can transition successfully, if appropriate, in the event of SCO staff separating from SCO for another opportunity or retirement.

CONCLUSION

The State Controller strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies as appropriate. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

Malia M. Cohen, State Controller

CC: California Legislature [Senate, Assembly]
      California State Auditor
      California State Library
      California State Controller
      Director of California Department of Finance
      Secretary of California Government Operations Agency