

Internal Controls for Payroll

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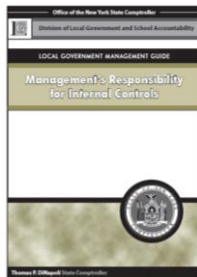
Division of Local Government and School Accountability



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Learning Objectives

- Definition
- Responsibility
- Origins and Framework
- Payroll Controls
- Available Tools
- Audit Findings



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Definition

- “A process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”
 - Internal controls are activities or procedures designed to provide reasonable assurance that operations are “going according to plan.”

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Responsibility

- Who is responsible for implementing internal controls?
 - **Management** – Including the Governing Board
- Who is responsible for monitoring internal control compliance?
 - **Management** – Including the Governing Board
- Who is responsible for following internal controls?
 - **Everyone!**

Origins and Framework

- The Committee of Sponsoring Organizations (COSO) of the Treadway Commission
- Five Elements of Internal Controls
 - Control environment
 - Risk assessment
 - Control activities
 - Communication
 - Monitoring

Control Environment

- “TONE AT THE TOP”
 - The governing board sets the proper tone for the control environment when it establishes and communicates a code of ethics, requires ethical and honest behavior from all employees, observes the same rules it expects others to follow, and requires appropriate conduct from everyone in the organization.

Control Environment

- Communicating expectation for entering and maintaining payroll data.
- Requiring employees to adhere to legal and policy requirements for protecting sensitive information and disseminating payroll data.
- Performing an adequate review of reports and supporting payroll records completed by employees, including management.

Risk Assessment

- Identify those events, conditions or risks that could significantly affect the achievement of the organization's objectives.

Risk Assessment

- Opportunity
 - Access to system changes, lack of oversight.
- Unfamiliarity
 - Changes to processing procedures, continuous IRS and system updates.
- Complexity
 - Withholdings, Payroll calculations

Risk Assessment

- Change
 - Turnover in positions, changes to employees positions, pay rates.
- Rapid Growth
 - Fast growth without increased staff/resources, frequency of payroll updates.

Understand the Risk

- Fraud Triangle – Pressure, Rationalization and Opportunity.
- Focus on what you can control – Opportunity
- Understand your process, ask questions and limit opportunity.
- Payroll can be complex.

Payroll Risk

- Theft
- Incorrect calculations/inputs
- Data loss/ breach (PPSI)
- Unauthorized access
- Time theft
- Authorizations (Changes, overtime)
- Legitimate employees
- Inappropriate benefits

Payroll Process

- Employment process
- System inputs for new employees
 - Changes for existing employees.
- Records completed by employees
- Supervisory authorizations
- Centralized payroll processing
 - Recording (including withholdings)
 - Reporting
- Payroll certification (various levels)
- Record maintenance and retention
- Monitoring and audits

Determine Risks by Asking Questions

- Who enters employee information?
- Who can change employee information?
- Who reviews employee information?
- Who reviews the payroll calendar?
- Are employees getting authorized benefits?
- How are supervisory authorizations documented?
- What level of authorization for overtime?
- Who verifies system updates?
- What is the certification process?

Control Activities

- Policies and procedures designed by management to help ensure that the organization's objectives and goals are not negatively impacted by internal or external risks.

Payroll Control Activities

- Directive Controls:
 - Job description, ethics policy, personnel policy, union agreements or other negotiated contracts, civil service laws and procedures, authorized benefits.
- Preventative Controls:
 - Segregation of duties, restricted access, time clocks, prescribed forms.
- Detective Controls:
 - Certifications, audits, change reports.
- Corrective Controls:
 - Employee training, disciplinary measures.

Understand the Need for Controls

Authorization Procedures

- 6-1-1 The governing board, or such other body or officer as authorized by law, should establish and approve all salary and hourly wages by position or as part of a collective bargaining agreement. Subject to statutory requirements and collective bargaining agreement provisions, the board or officer should also establish the frequency of all payroll distributions (biweekly, monthly, etc).

Reason for Control

Establishing salaries and wages and the frequency of payroll periods is generally part of the board's oversight responsibilities. These authorizations prevent other officers or department heads from establishing new pay rates or schedules without proper approvals.

- 6-1-2 The terms and conditions of collective bargaining agreements should be clearly communicated to those responsible for payroll processing.

Reason for Control

Terms and conditions of employment that are not clearly articulated to those responsible for executing payroll activities can lead to uncertainty about payments and benefits and the overall rights, duties, and responsibilities of employers and employees. This uncertainty could further result in unnecessary costs and/or grievances or litigation for a local government.

- 6-1-3 If not otherwise segregated under the law, segregate payroll authorizations (hiring/firing, pay rate setting, and other payroll changes) from the preparation and processing of payroll records and checks. In a computerized payroll system, payroll changes should be entered into the system by the personnel department or an employee who does not process the payroll register and checks, if possible.

Reason for Control

Segregating payroll authorizations from preparation duties reduces the risk of a single employee establishing ghost employees, increasing hourly rates and salaries, or recording overtime not worked without being detected.

- 6-1-4 Limit access to computerized payroll applications and data files containing potentially confidential information such as social security numbers and deductions.

Reason for Control

The payroll process involves a range of confidential and personal information. Hence, access to computerized applications and paper files (such as personnel files) should be restricted to the fewest number of officers and employees possible.

Payroll Change Procedures

- 6-2-1 All changes in employment status (e.g., additions and terminations), salary, and wage rates should be properly authorized, approved, and documented to support employment status changes. When appropriate, payroll change forms should be used to document and authorize wage and salary changes authorized by the governing board.

Reason for Control

When a formal process exists to document authorized changes to salaries and wages, the opportunity for fraudulent or erroneous payroll changes to occur without detection decreases.

- 6-2-2 If payroll change forms are used, control access to these forms by keeping them in a locked cabinet or drawer.

Reason for Control

Limiting access to payroll change forms reduces the risk that fraudulent authorization could be made by forging authorized signatures and other information.

- 6-2-3 Prior written authorization should be required for all nonemergency overtime hours and should be granted only for specific, verifiable purposes, consistent with any collective bargaining agreements. In emergency situations, supervisors should verbally pre-approve overtime to be incurred, and follow up with a review of overtime records to determine the appropriateness of overtime hours incurred.

Reason for Control

A simple way for hourly employees to perpetrate payroll fraud is to over-report overtime worked, particularly if supervisors are not on site during the overtime hours. Prior written or oral approval allows management to make sure that overtime is incurred for a valid and needed purpose, and that funding for the nonemergency overtime is provided for in the budget.

Time and Attendance Records

6-3-1 Require employees to document days and hours worked and leave credits used on either time sheets or time cards. Time sheets and time cards should be reviewed and approved by supervisory personnel who have direct contact with the employee.

Reason for Control

A lack of appropriate time and attendance records increases the likelihood that an employee could be paid for time not worked or for unauthorized absences.

6-3-2 Using time clocks to record arrival and departure times will provide additional control over days and hours worked by employees. Electronic time clocks can also reduce manual processing of payroll data if the time clock and payroll application are compatible.

Reason for Control

For local governments with large numbers of employees or where shift work is involved, an electronic time clock system will help ensure that employees are paid accurately for hours and days worked. An electronic time clock can also reduce data entry work if time clock entries can be downloaded directly into the payroll application.

6-3-3 Time clocks should be placed in an area where their use can be observed by supervisors.

Reason for Control

This will discourage employees from checking in or out for co-workers who are not actually present.

6-3-4 Require the use of leave request forms to document advance requests to use accrued leave credits and to document absences covered by the use of leave credits.

Reason for Control

Leave request forms provide an audit trail on the use of accrued leave credits and assist with the preparation of accurate gross payroll amounts for individual employees.

6-3-5 Maintain leave accrual records and communicate leave balances to employees regularly.

Reason for Control

Maintaining and reviewing leave accrual records ensures that such records are accurate and that employees only receive payment for leave time they are entitled to.

Verification Procedures

6-4-1 Even if not otherwise required by law, before checks are distributed, payroll registers or similar records should be certified by the officer or employee having direct supervision over specific departments or individual employees. The certification should indicate that to the best of the supervisor's knowledge, services were actually performed by the persons listed on the payroll and that days and hours worked are accurate and justified.

Reason for Control

A review of the completed payroll register will help detect unusual or inaccurate payments requiring further verifications before checks are distributed.

6-4-2 Management or the internal auditor should periodically review payroll change reports. When unusual changes are identified, those items should be traced to authorization documents (i.e., board minutes, payroll change forms, or collective bargaining agreements).

Reason for Control

Managerial review of this type of report provides assurance that payroll changes are being properly authorized and input correctly.

Payroll Check Procedures

6-5-1 Payroll checks should not be distributed to employees prior to the actual pay dates.

Reason for Control

The premature distribution of paychecks to employees creates the possibility that a check will be deposited or cashed by an employee prior to the date it is legally valid.

6-5-2 Undelivered payroll checks should be returned directly to the chief fiscal officer or other authorized officer for safekeeping and eventual cancellation, if warranted.

Reason for Control

Like all checks, undelivered payroll checks are negotiable instruments and unauthorized persons may attempt to cash them if the opportunity presents itself. Undelivered payroll checks should not be returned to the person who processes payroll records or to the person who performs the payroll bank reconciliation.

6-5-3 Requests for direct deposit should be made in writing and kept on file for audit purposes.

Reason for Control

Direct deposits can be used to disguise payments to nonexcess employees.

6-5-4 In local governments with more than 100 employees, as part of the direct deposit program, periodically require employees to pick up their payroll statement in person.

Reason for Control

In large units of local government, a once-a-year verification of the legitimacy of all direct deposits may detect unauthorized or fictitious employees. It may also detect the continuation of terminated or retired employees on the payroll.

6-5-5 Pay checks should be distributed by a responsible employee who is not otherwise connected with any of the steps of payroll preparation.

Reason for Control

This will separate the responsibility for processing payroll information from the distribution of payroll checks. In small local governments, employees can be required to call for their checks at a central location. In other governments, with a large number of employees and where the physical spread of work locations precludes central distribution, checks should be given out at the work station by someone who is not responsible for time and attendance reporting.

Reconciliation Procedures

6-6-1 Establish a separate bank account for payroll transactions.

Reason for Control

A separate bank account segregates net payroll checks, direct deposit transactions and withholding payments from other cash disbursements. The establishment of a separate bank account will ease the reconciliation of high volume payroll transactions and will also facilitate the identification of uncashed payroll checks.

6-6-2 Reconcile the payroll account monthly.

Reason for Control

Payroll is often one of the last bank accounts to be reconciled because it is generally a zero balance account. It is important to reconcile this account monthly so that uncashed payroll checks can be promptly identified and rectified.

6-6-3 The payroll bank reconciliation should be performed by an employee who is not connected with the authorization of payroll changes or with payroll preparation.

Reason for Control

Negotiating reconciliation dates from authorization and preparation dates provides for an independent review of transactions that have been processed by the bank and of outstanding checks.

Statutory Controls

6-7-1 A complete payroll should be submitted timely to the appropriate civil service agency or officer for certification.

Reason for Control

Section 100 of the Civil Service Law provides, among other things, that the Department of Civil Service or "municipal commission" having jurisdiction must certify that "the persons named on a payroll are employed in their respective positions in accordance with law and rules made pursuant to law" prior to an officer "approving or paying any salary or compensation." Section 100 also contains provisions relating to the time frames for obtaining the certification. For further information concerning this requirement, you should contact the State Department of Civil Service or your local civil service agency or official.

Assessing Controls

- Continuously assess controls that may be in place and determining if they are working properly and are efficient and effective.
 - Authorizations match system inputs.
 - Physical controls (i.e. time clocks) are working.
 - Prescribed forms used appropriately.
 - Output reports used by management.
 - Audits

Information and Communication

- Each employee should:
 - Understand their role;
 - Understand how their actions relate to others;
 - Understand that they have a responsibility to communicate problems they notice.
- Information and communication **MUST** be allowed to flow in all directions.

Information and Communication

- Training opportunities
 - Annual
- Review of policies and procedures
- Addressing consequences
- Reporting of inaccuracies
- Exceptions

Payroll Information and Communication

- What forms must be completed and by whom?
- What happens if an employee violates the policies or procedures?
- What are scenarios of situations to avoid?
 - PPSI training is crucial.
- What happens if a payroll error is detected?

Monitoring

- Monitoring determines whether or not policies and procedures are being followed.
- Monitoring identifies significant control deficiencies timely.

Monitoring

- Converting policies to actions.
- Personnel policies, contracts and bargaining agreements.
- No consequences.
- Finding the cracks:
 - Follow-up questions
 - See the evidence

Payroll Monitoring

- Payroll certifications
- Management review of output reports.
 - Addition reports
 - Change reports
 - Summaries and random audits
- System review
- Review of contracts and bargaining agreements and benefits.
- Budget reviews (object codes .1 and .8)

Don't take someone's word for it.

- Do not forget to ask follow-up questions and ask for evidence.
"Show Me... Let me see..."

Available Tools



Available Tools

- CPA Audit Reports
- OSC Audit Reports
- Policy Manuals and Procedures
- Training
- Other Municipalities/Districts
- Associations

Audit Findings

- Over/under payments
- Theft of time
- Unauthorized overtime
- Unauthorized benefits
- Inaccurate retirement calculations
- Unauthorized withholdings

Questions

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