CHAPTER 4
EFFECTIVE INTERNAL CONTROLS OVER PAYROLL

INTRODUCTION AND LEARNING OBJECTIVES

Every organization, including governments, require employees to assist in meeting their goals and objectives. The cost of employing these individuals are reflected in salaries and wages and the associated benefits. The principal purpose of any payroll department is to pay the employees and remit associated deductions, taxes, and benefits. Internal controls are necessary for this department to function effectively, efficiently and within the parameters set by management.

After completing this chapter, you should be able to

- Explain the payroll process
- Recognize the objectives for payroll
- Link the payroll objectives to the five interrelated components of an effective internal control system

DEFINING THE PAYROLL PROCESS

One of the largest expenditures for most governments is the payment of employees for providing services. The cost of paying employees includes not only the employees’ gross pay. It also includes the employer’s share of benefits. Often benefit costs make up nearly 40% of an employee’s gross pay. The following is an example.

The City of Vinson has an annual budget of $10,000,000. The budget can be summarized as follows –

Personnel $8,000,000
Operating $2,000,000

In this example, 80% of the budget is related to the payroll process. Strong internal controls are necessary to ensure financial data is accurate.

Many governments have a division of the accounting department dedicated to paying employees, called the Payroll Department. The size of the government determines whether the department is responsible solely for payroll or if payroll is just one of many responsibilities.

The Payroll Department is charged with paying employees accurately in accordance with policies and procedures established by the jurisdiction. A sample payroll cycle is exhibited below.
Governments may perform all of these steps, or may contract out a portion of the process to a third party processor. Regardless of the method used, the resulting amounts will be posted to the general ledger.

**OBJECTIVES FOR PAYROLL**

As we learned in Chapter 1, *Internal Control Review*, objectives are a prerequisite to the establishment of an effective internal control system. Those objectives are in three areas:
• Operations
• Reporting
• Compliance

Listed below are three basic objectives of an internal control system:

• Objective 1. To control operations by establishing various levels of authority, to provide approval for transactions and an adequate reporting system, and to enable those carrying out the approvals to be advised of the results from those approvals.

• Objective 2. To safeguard the organization’s assets from loss or damage as a result of waste, inefficiency, error, theft or fraud.

• Objective 3. To provide adequate information that is timely and reliable and supports the control structures so that individual management responsibilities can be identified.

To achieve these basic objectives, there are seven supplementary objectives that are also required to meet:

1. To ensure that all transactions are recorded. All valid transactions should be accurately recorded in the appropriate records, and valid transactions not recorded should be able to be detected by appropriate controls.

2. To record only valid transactions, and detect and protect against invalid transactions being entered.

3. To authorize only valid transactions and protect all records from unauthorized transactions.

4. To value transactions correctly and protect records from incorrect calculations and errors of recording.

5. To classify entries correctly in accordance with the chart of accounts or other categorizing requirements.

6. To record transactions in a timely manner so as to minimize errors caused by a delay between the transaction and its recording.

7. To include all transactions in the relevant subsidiary ledgers and correctly post them to the relevant ledger accounts.¹

Applying the above objectives of an internal control system, the objectives for payroll are as follows:

- All payroll transactions are preapproved.
- All valid payroll transactions are included in the accounting records in the proper period.
- All valid transactions are accurate, consistent with the originating transaction data, and information is recorded in a timely manner.
- All recorded payroll transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management’s general authorization.
- Access to payroll records are controlled and properly restricted to authorized personnel.
- Duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing a transaction.

AN EFFECTIVE INTERNAL CONTROL SYSTEM FOR PAYROLL

As we discussed in Chapter 1, *Internal Control Review*, an effective internal control structure has five interrelated components:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Each of these components is important in establishing and maintaining an effective control system for payroll.

THE CONTROL ENVIRONMENT AND PAYROLL

Controls can either be an entity control or an application control. The control environment is considered to be an entity control because it addresses characteristics from management’s
perspective rather than from an application such as payroll software. If the overall tone from management is not ethical and positive, then the possibility of the success of other internal control components is minimized.

The control environment is the foundation on which all other internal control components are built. Just as the foundation of a house ultimately supports the entire structure, so does the control environment support the internal control structure of an organization.

Let’s review the principles of the control environment. These include:

- Demonstrates commitment to and ethical values
- Exercises oversight responsibility
- Establishes structure, authority, and responsibility
- Demonstrates commitment to competence
- Enforces accountability

The control environment affects payroll by establishing protocols.

- A published code of ethics needs to be communicated with employees on a consistent basis. For example, employees should be required to read the code of ethics on entering the government’s workforce and reminded of that code of ethics at set intervals during employment. Also, management needs to visibly adhere to that code. The code of ethics could also be published on the government’s website.

- Personnel should be hired that have the knowledge and skills to accomplish payroll tasks. This characteristic can be accomplished by including appropriate knowledge and skills in the job description so that only qualified employees are hired. In addition, employees should be supervised by qualified personnel.

- The organizational structure of the payroll department should be such that there are job descriptions that provide for assignment of responsibility and authority. These job descriptions should allow for proper segregation of duties.

- Written procedures should be provided in the payroll area. These procedures should cover all phases of payroll from when an employee is hired through the employee’s separation from the government. Procedures should also address when an outstanding payment becomes legally an escheat property and submitted to the appropriate state agency.

- Management should exhibit a commitment to ongoing education and training process for employees in the payroll area. This is especially important due to frequent updates to deductions and withholdings from employees’ pay.
RISK ASSESSMENT AND PAYROLL

As discussed in Chapter 1, COSO defines risk assessment as the **identification and analysis** of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. In addition, objectives must be established before the assessment of risk can be undertaken.

Earlier in this lesson several objectives of payroll were outlined. In the risk assessment, each of those objectives should be examined in detail to determine or identify what could cause the objectives not to be met or achieved. After identifying the risks to achievement of each of the objectives, an analysis needs to be undertaken to determine what internal control activities are already in place and what internal controls need to be established to ensure that the objectives are met.

So, let’s take a look at each of the objectives noted for payroll and identify the risks to the achievement of each.

**Objective No. 1: Authorization**

Risks associated with proper authorization include –

- Hiring an employee that was not approved and who may not be legally eligible for employment. Federal law requires that all employees hired be determined eligible to work.

- Overspending the personnel budget may result from unauthorized hiring. Positions should be budgeted for each department in the government. Salary and benefits budgeted are based on these approved positions. Hiring an unauthorized individual may result in expenditures that were not approved in the budget.

- If an unauthorized employee is hired, it may result in an ineffective employee being placed in a position. Authorization should be obtained prior to hiring an employee to ensure that the appropriate supervisors make the final decision regarding the candidate’s qualifications.

- Incorrect employee classification for benefits eligibility and Fair Labor Standards Act status (i.e. those considered exempt versus non-exempt in terms of overtime payments) may occur if hiring does not follow the eligibility process. Eligibility for benefits is often determined by number of hours worked by an employee. Unauthorized hiring of an employee may result in a higher than budgeted cost due to a requirement to pay benefits that was not originally planned. The Fair Labor Standards Act includes criteria to determine whether an employee must be paid time and a half for overtime worked. The result of this improper classification is often an overspent budget.

**Objective No. 2: Safeguarding Assets**
Risks associated with safeguarding of assets include –

- An unqualified employee could be hired which might result in errors in the payroll process. Payroll is a specialized area that requires attention to detail. Employees expect their salary and wages to be accurate. Federal and state governments require that tax withholding will be accurate.

- Interest and penalties might be owed due to payroll errors. Both the federal and state governments have deadlines by which tax payments must be remitted. Failure to observe these deadlines might result in assessment of penalties and interest against the government.

- Fictitious employees may be added to the payroll. This risk is especially applicable to large governments in which the payroll department does not know each employee individually. When a fictitious employee is added to a payroll system, their resulting pay is typically deposited in the account of the employee who is defrauding the government resulting in the theft of assets.

- Employees may be incorrectly classified. Fair Labor Standard Laws and the Internal Revenue Service Code require proper classification of employees. It is important that employees be classified correctly regarding exemption status related to overtime pay. In addition, the proper classification should be made regarding worker’s status as an employee or an independent contractor. Mistakes in either of these classifications may result in significant assessments against the government.

- Employee may not properly report leave taken. Typically, annual leave balances are paid to employees upon separation. If an employee does not report leave taken, the government may pay for time not worked and leave not owed.

**Objective No. 3: Accurate, reliable and timely information**

Risks associated with providing accurate, reliable and timely information include –

- Employee’s salary or pay rate may be entered incorrectly. Incorrectly paying an employee will result in inaccurate data being included in the financial reports.

- Hours or pay period may be inaccurately entered. Payment for time not worked will result in overstatement of expenditures incurred or an unrecorded liability for time worked but not paid.

- Deduction data may be improperly entered. Deductions for health, dental, life, retirement, etc require payment to the vendor based on a predetermined schedule in order for coverage to be effective. Mistakes related to improperly withholding amounts could result in unrecorded liabilities for the government.
• Payroll may be generated but not posted to the general ledger. Accounting software requires transactions from the payroll module be posted to the general ledger by the user. A payroll may be generated but not posted resulting in an understatement of expenditures and an overstatement of cash in the general ledger.

CONTROL ACTIVITIES FOR PAYROLL

Control activities for payroll include the following:

Hiring

There should be a written process for hiring employees. The process should include –

• approval of the position from a budget perspective
• authorization to advertise
• receipt of appropriate application information
• participation in an established selection process
• offering of position with letter from chief executive that includes annual salary or hourly rate, benefits provided, status (full-time, part-time) and classification according to the Fair Labor Standards Act (exempt vs. non-exempt)

Documentation

Proper documentation should be completed and authorized by the employee. Deductions (other than for state and federal taxes) should not be withheld without a properly completed form from the employee. Forms to be completed include -

• Personal data form that includes identifying information
• Form I-9, Employment Eligibility Verification, determines eligibility to work in the United States. Employers should then verify the information provided using the E-Verify system.
• Form W-4, Federal Withholding,
• Form G-4, State Tax Withholding
• Benefits forms including health, dental and other plans
• Retirement plan forms

With advances in information technology and payroll software, forms may often be completed and submitted online. If your system allows online submission, ensure the transmission of data is secure and employees are identified by a user name and password.

Employees paid by direct deposit typically submit a cancelled check along with a completed authorization form. Submission of a cancelled check is an excellent control to ensure accurate data is provided for the transmission of an employee’s pay.

Authorization

To ensure that only valid transactions are entered into the payroll system, all transactions should be properly authorized. The following is a listing of necessary authorizations

• Time Sheets. Many employees complete time sheets for submission to payroll. The employee should sign the time sheet certifying that the time recorded was actually worked. The employee’s supervisor should approve the time sheet. The supervisor’s approval serves as authorization to pay the employee. The supervisor’s signature certifies the employee actually worked the time recorded.

In addition, time sheets should indicate any leave taken. Again, it is the supervisor’s responsibility to determine the employee properly recorded leave taken.

• Payroll. Payroll checks or direct deposit transmission data should not be generated until a supervisor has authorized the payroll. The Supervisor should verify all supporting documentation is present prior to approving the payroll. Depending on the payroll system, the approval may be manual (initials and date) or may be electronically approved.

Reconciliation

One of the most important control activities for the payroll process is reconciliation of amounts and accounts. The following is a listing of reconciliation activities –

• Hours worked. Hours entered into the payroll system from time sheets should be balanced to a summary report of hours worked generated from the payroll system.

Example – Mary has entered the hours from the department time sheets. When adding each of the time sheet totals, she obtained a control total of 160 hours. Mary generates a Time Worked report from the payroll system and sees that only 140 hours are shown. To identify the difference, Mary compares each time sheet to the record of time entered from the payroll report. She determines she only entered 20 hours for John Brown. Mary adjusts the time worked in the payroll system for John to 40 hours which was shown on his time sheet. She re-runs the payroll report and documents that now the report shows 160 hours worked which agrees to the total for all the time
sheets entered. Mary initials and dates the report from the payroll system to reflect that she successfully balanced hours worked with the payroll system.

- **Adjusted Gross Salary.** A number of employees are typically paid the same amount each pay period because of their classification as salaried employees. Therefore, the payments to these employees should only vary if there are adjustments to their pay.

  Example – Vinson Government has 20 employees who are considered salaried. The payroll is generated monthly. The typical gross payroll for all ten employees each month is $100,000. This month Jim Bulldawg’s check was reduced by $1,000 for leave taken without pay. When the payroll register is generated for the month, the gross pay for salaried employees should equal $99,000 ($100,000 normal balance less $1,000 deduction). Mary is reconciling the salaried payroll amount. The report reflects $99,000 for salaried employees. Mary initials and dates the payroll report to reflect that she successfully balanced adjusted gross salaries.

- **Taxable Wages.** Certain employee deductions are exempt from federal and state tax withholding. Examples of these deductions include those for retirement, contributions to deferred compensation plans, and deductions for Section 125 flexible benefits plans. Ensure that taxes are calculated on the proper gross amount by subtracting the total of pre-tax deductions from total adjusted gross wages. Payroll registers will typically reflect federal and state tax wages.

  Example – Mary is reconciling taxable wages. She begins with Adjusted Gross Wages of $99,000. She totals the pre-tax deductions as follows –

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement/Deferred Compensation Contributions</td>
<td>$5,000</td>
</tr>
<tr>
<td>Section 125 Flexible Benefits</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total Pre-Tax Deductions</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Next, Mary subtracts the $6,000 in pre-tax deductions from the Adjusted Gross Wages of $99,000 to get taxable wages of $93,000. Mary compares her calculation to the payroll register report of taxable wages and sees that the payroll register has total taxable wages of $94,000. Mary realizes that someone’s deductions have been set up incorrectly to withhold after tax. She reviews the changes in deductions for the current payroll. Shaun Bolt added a deferred compensation deduction of $1,000 this pay period. The deduction was NOT entered as a pre-tax item. Mary corrects the deduction and generates another payroll register. This time $93,000 is shown as the taxable amount. Mary initials and dates the total to show she has balanced the amount.

- **Retirement Contributions.** Often, retirement contributions are calculated as a percentage of employee gross salary. To ensure proper withholding occurs and the appropriate employer matching benefit is calculated, the payroll employee should recalculate the appropriate retirement contribution.
Example – Mary reviews the payroll register and determines the adjusted gross wages subject to retirement contributions is $99,000. The employees pay 5% of their adjusted gross wages for retirement. Therefore, the retirement deduction total on the payroll register should be $4,950. Mary sees that the deduction on the register is actually $4,800. Mary reviews the calculations by employee and determines 4% was added to Jamie Thompson’s employee record instead of 5%. Mary makes the change and generates a new payroll register. The total deduction is now showing as $4,950. Mary initials and dates this correct amount.

Mary reviews the employer retirement matching contribution of 5% and determines the amount is correct. Mary initials and dates the amount.

- Flexible Spending Account Deductions. Employees may annually elect to make contributions to flexible spending accounts. Unless there is a qualifying event (marriage, divorce, adoption), the employee may not make changes to the amount withheld during the year. To ensure proper withholding, the payroll employee should determine the correct amount was withheld.

Example – Mary reviews the record of flexible spending account elections and determines $1,000 should have been withheld. In reviewing the payroll register, Mary sees that only $950 was withheld. Mary reviews the deductions for each employee and determines that Jennifer Adams had a qualifying event and should have had an additional $50 withheld from her pay. Mary makes the correction, generates a new payroll register, and verifies the amount. She then initials and dates the report.

Similar procedures to the ones described above should be applied to remaining deductions.

Once the payroll is generated, control activities must be established to ensure direct deposit transmissions are sent, pay checks/remittance advices are delivered, and withholdings and deductions are paid. One way to ensure these processes are completed is to generate a checklist. The checklist should include the following tasks with a field to initial and date as the task is completed—

- Payroll balanced (this would be complete after reconciliation steps above are performed)
- Checks printed
- Payroll transmitted to bank
- Federal taxes remitted
- State taxes remitted
- Retirement contributions remitted
- Flexible spending accounts remitted
• Other withholdings and deductions remitted

Once all liabilities are paid, the final reconciliation item is to review payroll liability accounts to ensure all balances are zero. If balances remain, generate a general ledger detail to determine which amount remains unpaid or if an error occurred. This can be accomplished by comparing the amounts posted to the payroll accounts from the payroll system with amounts paid to benefit providers and state and federal governments.

INFORMATION AND COMMUNICATION OF PAYROLL

From the discussion in Chapter 1 on information and communication, we learned that for any organization to run and control its operations, reliable and accurate information is a must. Information must flow up, down, and across the organization, as well as in and out of the organization. Information can be formal or informal. With these characteristics in mind, let’s consider for a moment what information would be required to be communicated about payroll.

The following are examples of what needs to be communicated about payroll, however, the list is not all inclusive. The needs of your government may require your information and communication list to be quite different.

1. Enrollment periods for benefits. Information should include plan options and dates for enrollment.

2. Pay periods and dates. Information should include dates of pay period, due date for time sheets, and pay date.

3. Holidays. Scheduled paid holidays should be communicated.

4. Furlough days. If the government has scheduled furlough days, the dates should be communicated to the employees.

5. Personnel policies and procedures. Employees should have access to detailed policies and procedures related to employment with the government.

6. Salary information. Employees should receive annual notification of changes in pay rate or salary.


8. Tax withholding. Tax withholding payments and required reports must be sent to federal and state government agencies.
MONITORING AND PAYROLL

Monitoring, the fifth internal control element, ensures that the internal controls operate as intended over time, and is accomplished through on-going evaluations, separate evaluations or a combination of both. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. Ongoing monitoring in payroll takes the form of supervisory activities. Payroll reconciliations should be reviewed by an appropriate level supervisor. The supervisor should initial and date the face of the reconciliation as evidence of the review. The payroll supervisor or another member of management should review all changes to employee information. This can be easily accomplished by regularly producing an employee addition/change report.

Separate evaluations of internal controls are those completed by persons outside of operations; however, the objectives of this type of evaluation are the same as the ongoing, routine evaluations. Specifically, to enable management to determine if internal controls continue to function over time and to provide a communication tool for identified control deficiencies.

Separate evaluations take place after the fact. These evaluations can be incorporated into the annual audit of financial statements or can be a separate contractual agreement with an external public accounting firm. Separate evaluations can also be a function of internal audits.
CHAPTER 4 SUMMARY

1. Payroll can be defined as the process to pay employees for services rendered. The process includes deducting or withholding authorized amounts from employees’ pay and remitting to the appropriate vendor or governmental entity.

2. Objectives for payroll are as follows:

   - All payroll transactions are preapproved.
   - All valid payroll transactions are included in the accounting records in the proper period.
   - All valid transactions are accurate, consistent with the originating transaction data, and information is recorded in a timely manner.
   - All recorded payroll transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management’s general authorization.
   - Access to payroll records are controlled and properly restricted to authorized personnel.
   - Duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing a transaction.

3. 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. The risks associated with each of the payroll objectives should be evaluated.

4. Information to be communicated about payroll can vary between governments. The following are typical items that are communicated in payroll:

   - Enrollment periods for benefits. Information should include plan options and dates for enrollment.
   - Pay periods and dates. Information should include dates of pay period, due date for time sheets, and pay date.
   - Holidays. Scheduled paid holidays should be communicated.
   - Furlough days. If the government has scheduled furlough days, the dates should be communicated to the employees.
   - Personnel policies and procedures. Employees should have access to detailed policies and procedures related to employment with the government.
   - Salary information. Employees should receive annual notification of changes in pay rate or salary.
   - Benefits payment. Benefit providers must receive information regarding employee enrollments.
   - Tax withholding. Tax withholding payments and required reports must be sent to federal and state government agencies.

5. Monitoring in payroll takes the form of supervisory activities. Reconciliations should be reviewed by an appropriate level supervisor. The supervisor should initial and date the face of the reconciliation as evidence of the review.
6. The payroll supervisor or another member of management should review all changes to employee information. This can be easily accomplished by regularly producing an employee addition/change report.
CHAPTER 4 EXERCISE

INSTRUCTIONS: Fill in the blanks with the correct answer.

1. ______________ is defined as a process to pay employees for services rendered.

2. Monitoring takes the form of ______________ activities.

3. List three control activities for payroll

_________________________________________

_________________________________________

_________________________________________

4. List four examples of payroll information to be communicated.

_________________________________________

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_________________________________________

_________________________________________

5. ______________ _______________ is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed.

6. What is one control activity you plan to implement as part of your government’s system of internal controls for payroll? Explain why?