



Internal Control for Payroll

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Promoting Excellence in Government

Payroll Nightmare!



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Learning Objectives

Define the payroll process

Recall components and principles of internal control

Explain how creating and documenting a system of internal control can assist management in meeting payroll objectives

Payroll Process Defined

What is Payroll?

The principle purpose of any payroll department is to **pay** the organization's employees

Payroll is the process of paying an organization's employees



Employee Earnings

- Determined by agreement between employer and employee
- Salary schedule
 - Position title
 - Steps/years of experience
- Employees pay examples:
 - Annual salary/prorated over pay periods
 - Hourly rates paid based on hours worked
- Pay periods vary—monthly, semimonthly, biweekly or weekly
- FLSA—150% regular rate for 40+ hours with certain exemptions



Employee Earnings

- Time sheet
 - Basis of non-exempt payroll
- Contents of time sheet
 - Employee name
 - Pay period
 - Dates worked
 - Number of hours worked
 - Leave
 - Accounting distribution
 - Approval
 - Employee
 - Employer



Payroll Journal

- Special Journal
 - Sometimes call Payroll Register
- Common contents:
 - Name of employee
 - Expenditure distribution
 - Gross payroll
 - Adjustments to gross payroll
 - Adjusted gross payroll
 - Net payroll



Payroll Deductions

- Social security tax
- Medicare tax
- Federal, state, local income taxes
- Deferred compensation
- Pension contribution
- Benefit deductions
- Other deductions



Recording the Payroll

	<u>DR</u>	<u>CR</u>
Expenditure Control	\$ 24,648	
FICA Payable (liability)		\$ 1,866
Federal Income Tax Payable (liability)		4,897
State Income Tax Payable (liability)		1,275
Pension Retirement Payable (liability)		786
Deferred Compensation Payable (liability)		3,500
Cash in Bank (asset)		12,324

Recording Employer's - Share of Benefits

	<u>DR</u>	<u>CR</u>
Expenditure Control	\$ 4,908	
FICA Payable (liability)		\$ 2,573
Pension Retirement Payable (liability)		\$ 2,335

Payroll and Internal Control

What Are Internal Controls

Internal Control Integrated Framework COSO

Process effected by an entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the objectives relating to operations, reporting, and compliance.

Standards for Internal Control in the Federal Government

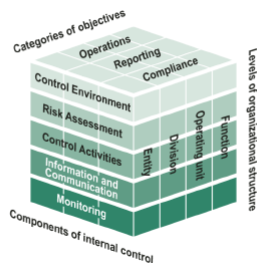
GREEN BOOK

Process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives will be achieved.

- Operations
- Reporting
- Compliance

How Is Internal Control Organized?

Figure 4: The Components, Objectives, and Organizational Structure of Internal Control



17 Principles

Sources: COSO and GAO. | GAO-14-704G

Green Book p10

Control Environment

Control Environment

Foundation for internal control system providing discipline and structure which affects the overall quality of internal control

5 Principles

Oversight Body Demonstrates Commitment to Integrity and Ethical Values

Communicate published code of ethics to employees

Oversight Body Oversees Internal Control System

Auditors report directly to oversight body

Management Establishes Organizational Structure, Delegates Authority, Assigns Responsibility

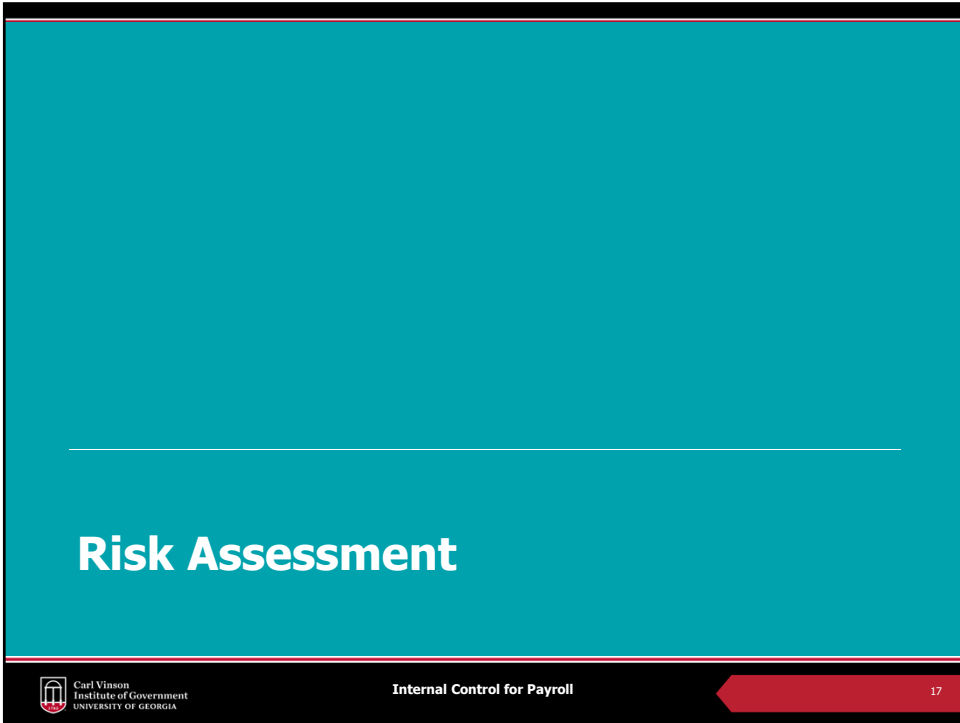
Provide job descriptions with proper segregation of duties for responsibility and authority

Management is Committed to Recruit, Develop and Retain Competent Individuals

Hire those with right knowledge and skills to accomplish tasks

Management Evaluates Performance and Holds Individuals Accountable for Their Internal Control Responsibilities

Annual employee performance evaluation

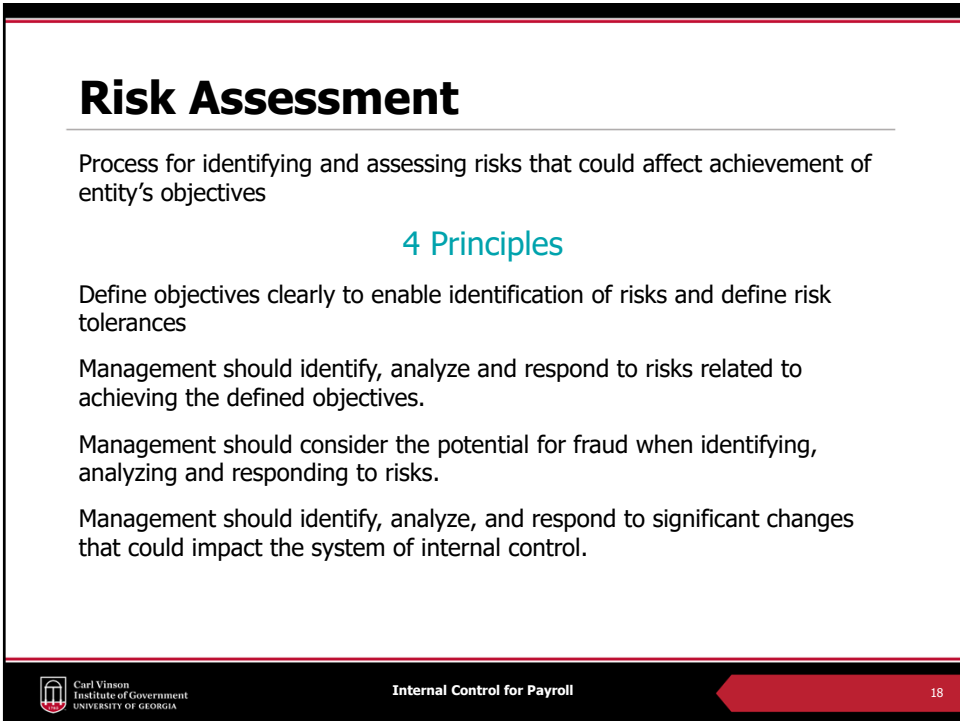


Risk Assessment

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Risk Assessment

Process for identifying and assessing risks that could affect achievement of entity's objectives

4 Principles

- Define objectives clearly to enable identification of risks and define risk tolerances
- Management should identify, analyze and respond to risks related to achieving the defined objectives.
- Management should consider the potential for fraud when identifying, analyzing and responding to risks.
- Management should identify, analyze, and respond to significant changes that could impact the system of internal control.

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Risk Assessment – Payroll Objectives

Objective 1 – Authorization, Transactions are preapproved, authorized by management and have occurred

Objective 2 –Safeguarding Assets, Payroll and employee records are controlled and restricted to authorized personnel

Objective 3 – Accurate, Reliable and Timely Information, Transactions are accurate, agree with source documents, recorded in timely manner and have proper cut-off

Objective 4 – Segregation of Duties, Employee assignments are designed so that no one individual can control recording and processing transactions

Risk Assessment

Objective No. 1: Authorization



Risks:

- Unauthorized employee is entered into system or remains in system after termination
- Unauthorized personnel have access to confidential employee data
- Payment for hours not worked
- Payroll is processed without proper authorization

Risk Assessment

Objective No. 2: **Safeguarding Assets**



Risks:

- Employee data is breached
- Unauthorized pay rate is entered
- Leave taken not properly entered

Risk Assessment

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



Risks:

- Key payroll employee departs leaving inexperienced staff in charge
- Payroll cannot be generated due to lack of required approvals
- Salary/pay rate are not properly updated
- Hours/pay period inaccurately entered or not updated
- Deduction information entered improperly or updates not posted in a timely manner
- Payroll is generated but is not posted to the general ledger
- Account distribution codes are not updated
- Electronic payment file is not transmitted to the financial institution in a timely manner

Risk Assessment

Objective No. 4: Proper Segregation of Duties

Duties are assigned to individuals in a manner that ensures that no one individual can control both the procedures relative to processing a transaction and the recording function

Risks

- Due to vacancies, one individual is responsible for processing and recording the payroll offering an opportunity for errors or irregularities
 - Personnel may enter a fictitious employee or pay a previously terminated employee and deposit funds to their own bank account
 - Payroll errors go undetected due to lack of appropriate review

Control Activities

Control Activities

Actions management puts into place to reduce identified risk

3 Principles

Management should design control activities to achieve objectives and respond to risks

Management should design entity's information system and related control activities to achieve objectives and respond to risks

Management should implement control activities through policies.

Control Activities

Objective 1 – Authorization

Risk - Unauthorized employee paid

Control Activity - Written process for hiring

- Budget approval
- Authority to advertise
- Appropriate applicant information
- Established selection process
- Formal job offering (Letter)

Control Activities

Objective 1 - Authorization

Risks – Payment for hours not worked, Payroll processed without approval

Control Activities

- Required to ensure that only valid transactions are entered into payroll system
 - Time sheets approved by employee and supervisor
 - Supervisor's approval = authorization to pay and certifies time recorded is actual time worked.
 - Payroll should be authorized by supervisor
 - Verify that all supporting documentation is present prior to approving payroll
 - Could be manual or electronic approval

Control Activities

Objective 2 – Safeguarding Assets

Risks – Data breach, unauthorized pay rate, leave not entered

Control Activities

- Access to employee confidential data should be restricted to those required to make changes
- Gross salaries control total, reasonableness test
- Leave sheets approved by supervisor compared to leave entered into payroll

Control Activities

Objective 3 – Accurate, reliable, and timely information

Risks – Lack of approval, pay rates and hours not updated, deduction information incorrect or not posted, no general ledger posting, account codes not updated, electronic payment file not transmitted

Control Activities

Approval rights given to more than one supervisor

Pay rates are updated and verified by a separate employee

Hours entered into payroll system agrees to timesheets

Deduction information is verified against source documents

Employee assigned responsibility to update general ledger and verified by supervisor

Written process for updating account distribution codes

Deadlines established for transmitting electronic payment file with backup plan

Control Activities

Objective 4 – Segregation of Duties

Risks – Fictitious employee, payroll errors

Control Activities

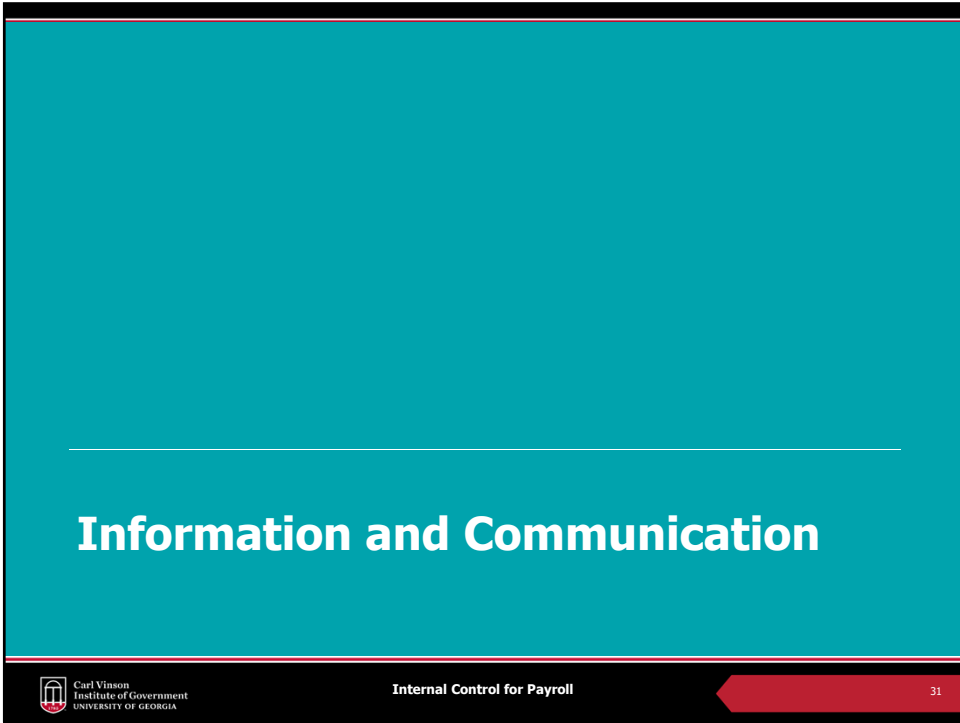
Do not allow one employee to be responsible for the following

Authorization, New hires, pay rates, and check signing

Custody of Assets, Access to bank accounts or mailing checks

Record Keeping, Preparing source documents, maintaining ledgers, preparing reports

Reconciliations, Preparing payroll liability account reconciliations and bank reconciliations

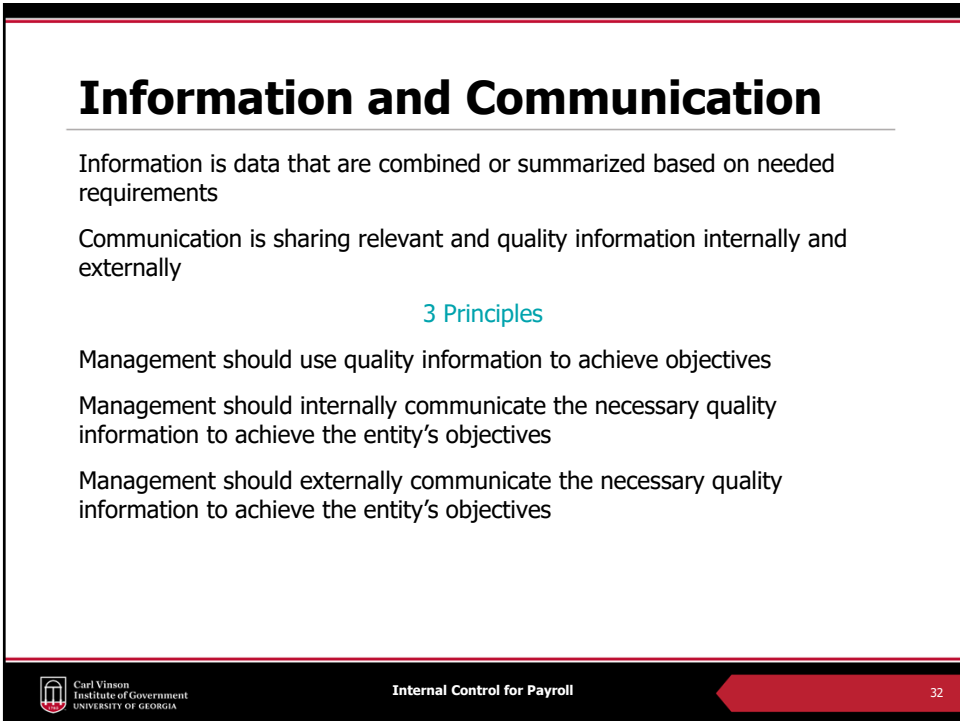


Information and Communication

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Information and Communication

Information is data that are combined or summarized based on needed requirements

Communication is sharing relevant and quality information internally and externally

3 Principles

- Management should use quality information to achieve objectives
- Management should internally communicate the necessary quality information to achieve the entity's objectives
- Management should externally communicate the necessary quality information to achieve the entity's objectives

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Information and Communication

Examples of quality information

- Enrollment periods for benefits
- Pay periods and dates (cutoff)
- Holidays
- Furlough days
- Personnel policies and procedures
- Salary information (pay scales)
- Benefits payable due dates
- Tax withholding due dates



Information and Communication

Internal communication

- Recurring payroll department meetings
- Memos
- Policies and procedure manual
- Emails
- Shared drive for storing content
- Training

Information and Communication

External Communication

- Meetings
- Website
- Emails
- Policies
- Announcements
- Training

Monitoring Activities

Monitoring Activities

Methods to determine internal control system continues to operate as intended

2 Principles

Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.

Management should remediate internal control deficiencies on a timely basis.

Monitoring Activities

Internal Audit - Review all changes to employee information/forms for accurate and timely posting

Agreed upon procedures – outside CPA perform

Supervisory Review – Use system documentation to ensure policies and procedures put into place are still functioning as intended

Corrective Action Plan – management assigns responsibility for correction action for noted deficiencies and follows up on action taken

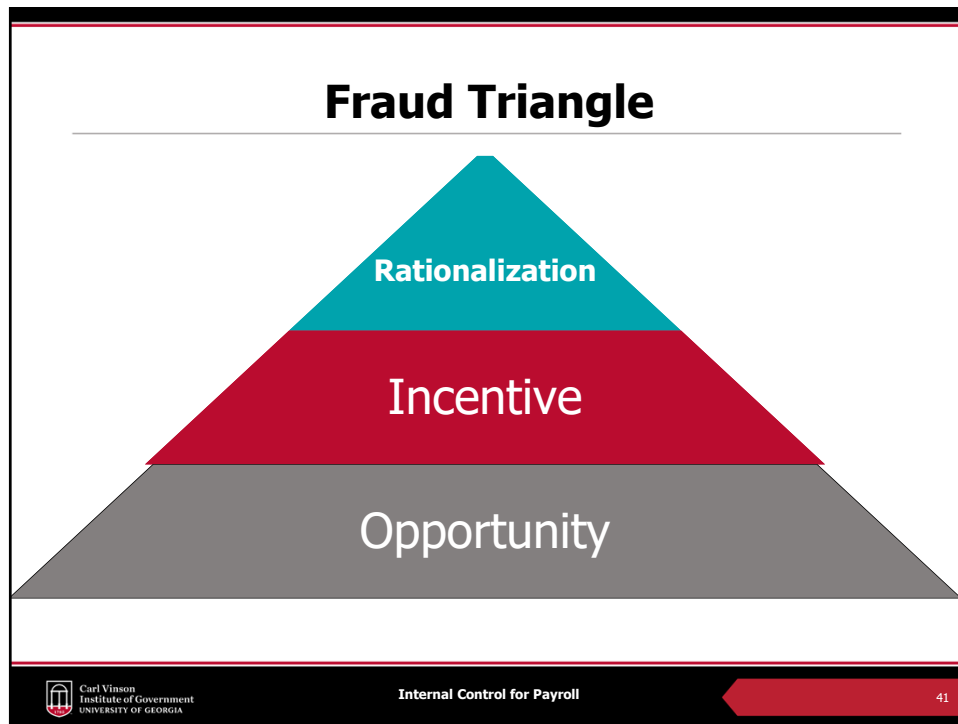


Fraud

An Overview

Association of Certified Fraud Examiners (ACFE) Definition

*Fraud is the use of one's occupation for **personal enrichment** through the deliberate misuse or misapplication of the employing organization's resources or assets*



Rationalization

Behaviors are logically justified

Examples include:

- "I get no respect and I will get even."
- "Joe makes more money than I do and I have more experience."
- "I only got a 2% raise this year – everybody else got more."

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Incentive

Something that motivates someone to commit fraud

Examples of incentives include:

Financial stress – Unpaid medical bills

Addictions – Gambling, drug, alcohol

Pathologies – Intellectual challenge

Opportunity

Not only permits fraud to occur, but actually promotes it

Lack of sound and comprehensive framework of internal controls



Association of Certified Fraud Examiners

Report to the Nations

2018 Global Study on Occupational Fraud and Abuse

<https://www.acfe.com/report-to-the-nations/2018/>

Payroll Fraud

- Typically lasts 30 months before detection
- Small companies (<100 employees) have higher number of fraud cases as compared to employers with > 100 employees
- Smaller companies have fewer fraud controls due to fewer resources
- Smaller companies rely more heavily on trust as a control
- Fraud at smaller companies result primarily from lack of controls

Fraud Detection

Tips 40% (hotline, email, web-based form, letters)

Internal audit 15%

Management review 13%

By accident 7%

Other 6%

Account reconciliation 5%

Document examination 4%

External audit 4%

Other 6%

Antifraud Controls

Code of conduct

External audit of financial statements

Internal Audit

Management certification of financial statements

Management review

Hotline

Antifraud policy

Fraud training for employees

Internal Control Weaknesses

- Lack of internal controls
- Override of existing controls
- Lack of management review
- Poor tone at the top
- Lack of competent personnel

What can you do?

- Develop a strong system of internal control and follow it
- Consequences for those who don't follow system of internal control
- Hire qualified employees and continue their training
- Have methods for employees to report fraud
- Managers should perform their reviews on a timely basis
- Send the right message from the top (oversight body and leadership)

Resources

Internal Control

- Committee of Sponsoring Organizations (COSO)
 - <http://www.coso.org/guidance.htm>
- Standards for Internal Control in the Federal Government (Green Book)
 - <http://www.gao.gov/greenbook/overview>
- GFOA
 - <http://www.gfoa.org/internal-control-framework>

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