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# Best Practices and Pitfalls– Payroll and Related Liabilities

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# What is on the Agenda Today!

- Why Are We Talking About Payroll - OSA findings report
- Internal Control Basics
- COSO Integrated Framework
- Payroll Controls
- Errors that Could and Have Happened

# Internal Controls – Basics

- Understanding Internal Controls
  - Internal Controls – A **process**, affected by those charged with governance, management, and other personnel, designed to provide assurance about the achievement of the entities objectives.
  - Entities’ objectives – Reliable financial reporting, efficiencies and effectiveness of operating, compliance with applicable laws and regulations.

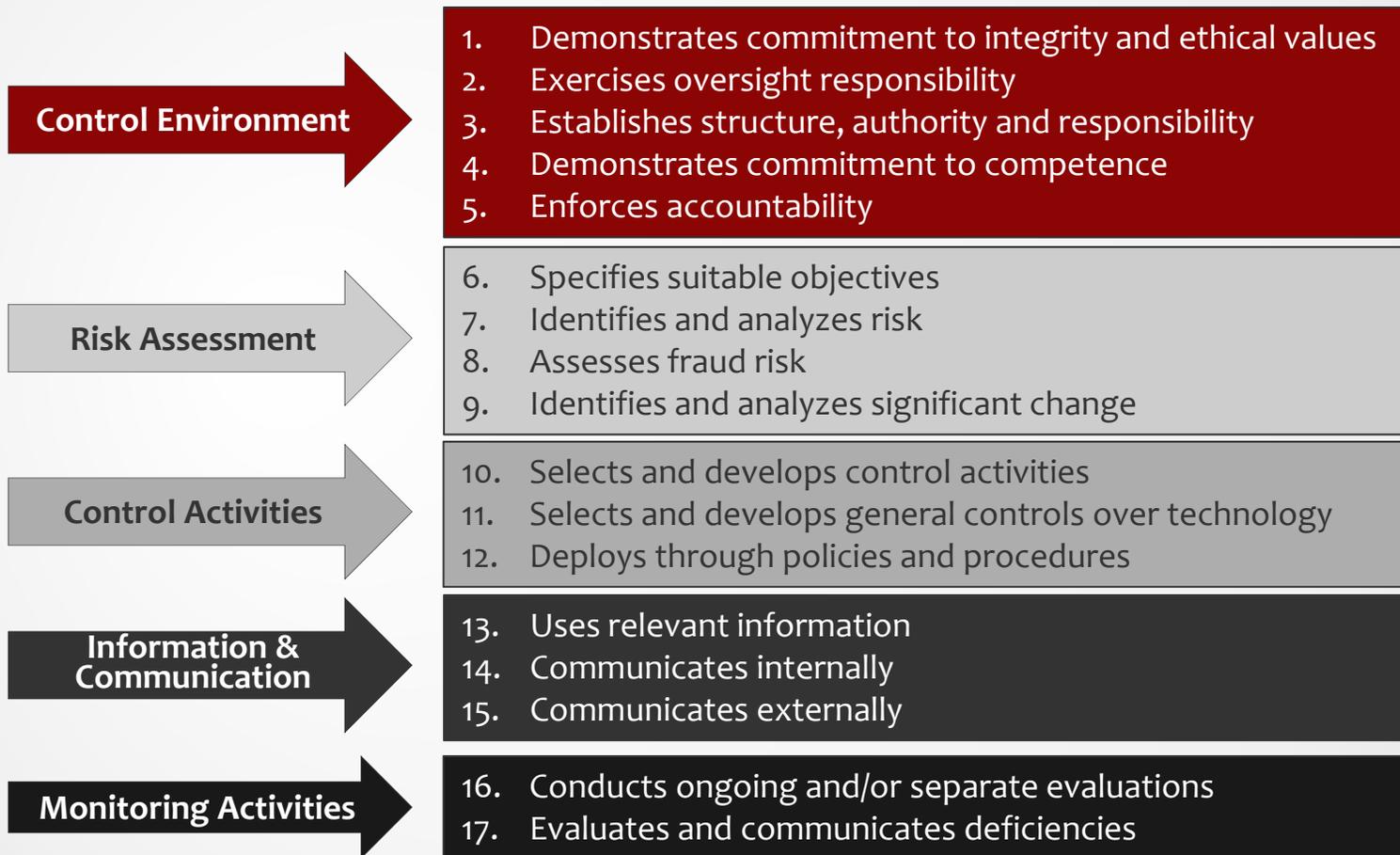
# Internal Controls – Basics

- Committee of Sponsoring Organizations (COSO)
  - The COSO Framework for internal controls represents means used by an entity to help achieve their objectives.
  - Updated in 2013 – Effective after December 15, 2014
    - Retained underlying principals – builds on the original framework

# Internal Controls – Basics

- Entity Level Controls
  - Control Environment
  - Risk Assessment
  - Information and Communication
  - Monitoring
  - Financial Close and Reporting
  - IT General Controls
- Activity-Level Controls (Cash, Revenue, Expenditures, Capital Assets, etc.)

# COSO Update – Principles of Effective Internal Control



# COSO Update – Clarifying Effective Internal Control

- Effective internal control provides reasonable assurance regarding the achievement of objectives and requires that:
  - Each component and each relevant principle is present and functioning.
  - The five components are operating together in an integrated manner.
- Each principle is suitable to all entities; all principles are presumed relevant except in rare situations where management determines that a principle is not relevant to a component (e.g., governance, technology).

# COSO Update – Categories of Objectives

- Operations: Directed to effectiveness and efficiency, including operational and financial performance goals and safeguarding assets from loss.
- Reporting: Relate to internal and external financial and non-financial reporting, including reliability, transparency, timeliness, or other terms determined by standard setters, regulators, or the policies of the organization.
- Compliance: Pertain to adherence to applicable laws and regulations.

# Internal Controls – Five Components of the COSO Integrated Framework

- Control Environment
  - Sets the tone of an organization.
  - Foundation for all other components of internal control, providing discipline and structure.
  - Factors include the integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization.
- Risk Assessment
  - External and internal sources that must be assessed.
  - Identification and analysis of relevant risks to the achievement of assigned objectives.
  - Evaluating what could go wrong.

# Internal Controls- Five Components of the COSO Integrated Framework

- Control Activities
  - Policies and procedures that help ensure management directive are carried out.
- Information & Communication
  - Flow of information and how it is communication both upstream and downstream.
- Monitoring
  - Internal control processes need to be monitored.
  - According to COSO, if internal controls are not monitored they do not exist.

# Control Environment - Effects on the Entity

- How does this relate to my role at the Entity?
  - Must exercise a “tone at the top” that will not deviate from established internal controls
    - If a deviation occurs, what are the consequences? Are they communicated?
    - Does the City Council, County Manager, Superintendent, etc., and all of top management abide by the policies in place?

# Risk Assessment - Effects on the Entity

- How does this relate to my role at my Entity?
  - Must continually assess the risks that are present regarding the internal control structure
    - Evaluating what could go wrong?
    - What if there is turnover in certain departments?
    - What are the assets that must be safeguarded?
    - Is more training needed?
    - Is this part of the hiring practices?

# Control Activities - Effects on the Entity

- How does this relate to my role my Entity?
  - Must implement a system to respond to the risks and achieve the objectives set forth by the governing body
    - Safeguard assets
    - Promote timely, accurate and reliable financial reporting
    - Ensure department heads are executing a control environment that is in line with the overall control environment

# Info and Communication - Effects on the Entity

- How does this relate to my role at my Entity?
  - Is there a methodology for gathering this information and disseminating it throughout the Entity? What is the best way to communicate this to department heads, administrators, and all the employees?
  - Does no good to have the best internal controls designed but can't get the information out to the departments and locations

# Monitoring - Effects on the Entity

- How does this relate to my role at my Entity?
  - Last, but not least (in fact the most important), how to monitor the internal controls
    - Continued evaluation of the design
    - Evaluate effectiveness
      - Do you test internal controls over financial reporting and over compliance?
      - Do you look at transactions and ensure they are subject to what is supposed to happen?

# Monitoring - Effects on the Entity

- How does this relate to my role at my Entity?
  - Monitoring (continued)
    - What are some methods for monitoring internal controls?
      - Periodic evaluation and testing by internal audit
      - Using information systems
      - Analysis and follow up on reports that might identify anomalies indicative of control failure
      - Supervisory reviews
      - Self assessments of the “tone at the top”

# Control Environment - Effects on the Entity

- How does this relate to my role at my Entity?
  - Monitoring (continued)
    - When problems are identified, do you correct them on a timely basis?
    - Taking corrective action
    - Evaluation of the organizational structure
      - Look at capabilities, objectivity, and authority

# Internal Controls

- Two Types of Internal Controls
  - Preventative
    - Designed to provide reasonable assurance that only valid transactions are recognized, approved, and submitted for processing. Most preventative controls are applied before the processing activity occurs.
  - Detective
    - Detective controls are designed to provide reasonable assurance that errors or irregularities are discovered and corrected on a timely basis. Detective controls are normally performed after processing has been completed.

# Examples of Internal Controls

- Purchase Orders
- Having an independent employee review the accounts payable master list periodically to ensure only valid vendors have been added
- Conducting periodic surprise inventory counts
- Bank Reconciliations Reviewed Timely (Documented)
- Using Pre-Numbered Receipting
- Locking Up Blank Check Stock
- Three Way Match (PO, Invoices, Check)

# Internal Controls

- Key Controls
  - Controls that significantly reduce the chance of a material misstatement or material noncompliance.

# Internal Controls

- Evaluating Internal Controls
  - Design and Implementation
  - Operating Effectiveness

# Evaluating Control Design

- The process for evaluating control design includes your consideration of:
  - The risk of what can go wrong at the assertion level.
  - The likelihood and significance of the risks, irrespective of internal control considerations.
  - The relevant control objectives.
  - The controls, either individually or in combination, that satisfy each control objective.

# Evaluating Control Design

- To evaluate whether controls have been designed to satisfy each control objective, it is helpful to consider:
  - Whether the control or combination of controls would – if operated as designed – likely meet the control objective.
  - Whether the controls necessary to meet the control objective are in place.

**The control objective for control activities in ICFR are the financial statement assertions**

# Determining if the Control Has Been Implemented

- Determining whether a control has been implemented is important because it confirms your understanding of control design and helps ensure that your risk assessment is based on accurate information.
- However, it is not unusual for personnel to use a control differently from the way it is described in the policy manual or in response to inquiries you make of someone else.
  - Example: Client accounting policy manual may state that physical inventory accounts are performed annually. However, due to increases in the volume of transactions, client deviates from stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company.

# Determining if the Control Has Been Implemented

- The determination of whether a control has been put in place and is implemented involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have:
  - An awareness of the existence of the procedure and their responsibility for its performance, and
  - A working knowledge of how the procedure should be performed.
- Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

# Internal Control Over Financial Reporting (ICFR)

- If a weakness in design or implementation is noted during the audit it can result in:
  - Material Weakness
    - A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis
  - Significant Deficiency
    - A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance

# Sample Payroll Controls

- How often does management review financials?
- Are bank reconciliations prepared and reviewed in a timely basis?
- Is access to data and/or transactions restricted?
- Does management review the payroll system master file?
- Does Entity compare current payrolls with previous payrolls?
- Are payroll registers reviewed after processing, reconciled to control totals, and approved by appropriate level of management?

# Segregation of Duties

In the perfect world you would have different people doing the following tasks:

- Prepare payroll checks
- Sign payroll checks
- Review and authorize electronic payroll disbursements
- Resolve employee payroll inquiries
- Edit the payroll master file
- Open mail and deliver checks

# What Can Go Wrong?

- Without Controls, the Entity is subject to:
  - Computer Access (AP Clerk change payroll, Payroll and HR Separate, Job changes, Backup Person/Policy)
  - Ghost Employees
  - False Pay Changes
  - Former Employees Still Receiving Checks
  - False Overtime
  - Incorrectly Paying Substitute who didn't work
  - Taking Leave and Getting Paid or Over Accruing Leave
  - Tax and Benefit Penalties if not paid timely (Costly to students)
  - Additional Compensation/Stipends (After School Tutor)
  - Anti-Donation (Bonuses)
  - False or Inaccurate Time Sheets (Electronic vs. Manual)

# Payroll Issues Noted Through Experience

- Over my career auditing Government entities, I have noted:
  - False Overtime
  - False Hours (Subs, Security, Umpires/Referees, etc.)
  - Family Members on Payroll (Not Employees)
  - Di Minimis Theft
    - Alamogordo Schools has a policy on this
  - Over Accruing Leave (calculation too high, leave not being removed once used)
  - Taking Leave and Getting Paid on Same Days
  - Overwriting Electronic Time Sheets
  - Bonuses
  - Fines and Penalties for Taxes
  - IRS Audits on Contractor Designation (Employees)?
  - Improper Pay Raise Authorization (can't prove)

# OSA Findings Report

- Total of 252 Findings in this area:
  - Classification of employees
  - Paying or accruing wages and or PTO at the wrong rates
  - Being paid in advance
  - Personal use of autos without being added to W-2
  - Terminated employees – still getting paid, accruing PTO, not done timely
  - Lack of internal controls or all aspects of payroll
  - Calculating checks wrong
  - Recording and calculating payroll liabilities incorrectly
  - Timesheets missing, not approved or incorrect
  - Payroll reports- everything possible was wrong

# OSA Findings Report

- Personnel Files (items missing or incorrect):
  - Background checks
  - Identification forms
  - Work permits
  - New hire paperwork and approvals
  - Licenses
  - I-9 and w-4's
  - Applications
  - SSA 1945 forms
  - Various Reports to the State
  - Current contracts
  - Approvals
  - Withholdings authorizations

# Thank You



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