

PAYROLL AUDIT

INTERNAL AUDIT REPORT 08-01

INTRODUCTION

The City of Sioux Falls City Council authorized this audit in the 2008 Annual Audit Program. This is the first internal audit of payroll.

BACKGROUND

The City of Sioux Falls employs about 1,100 permanent employees and hundreds of seasonal and temporary employees. The City's payroll is over \$60 million annually. This figure represents the largest portion of the City's operating budget. The City operates under a biweekly pay period system. Employees are normally paid every other Friday. Human Resources is responsible for the overall administration of payroll. However, each major organizational unit (MOU) has employees with pay clerk responsibilities. This means that these employees enter payroll information each week and must be aware of the special pay considerations for the various employee groups in their MOU. Pay clerk duties may be a small part of their regular duties. Benefit technicians and managers in Human Resources monitor the performance of these pay clerks.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were as follows:

- 1 To determine whether all current employees already on the City payroll are bona fide (no ghost employees).
- 2 To determine whether all new hires for the City were accurately and completely recorded in the payroll system.
- 3 To determine whether payroll data is completely and accurately accumulated in the City's financial records and federal payroll tax information reported is accurate and timely.
- 4 To determine whether there is adequate segregation of duties in the payroll process.
- 5 To determine whether there are adequate controls over the process of printing paper payroll checks.
- 6 To determine whether employees ending their employment were properly recorded and processed in the payroll system.
- 7 To determine whether payroll and employee information is properly secured and access restricted to the appropriate personnel.

This audit focused on payroll transactions from January 2007 through February 2008. Specifically excluded from the audit scope was a review of actual time sheets. Time sheets are regularly audited by Human Resources (see Noteworthy Actions section on page 2). Internal Audit will look at a sample of payroll time sheets when we do an audit of city-wide disbursements later this year.

To accomplish our audit objectives, we interviewed staff and management, examined written procedures, examined personnel files and financial records, and reviewed audit literature on payroll risks and controls. We reviewed relevant internal control structures. We used data extraction software for several audit tests. Data extraction software allows auditors to examine 100% of payroll records and sort and filter data to identify anomalies for more detailed examination.

NOTEWORTHY ACTIONS

In 2001, Human Resources initiated regular audits of major organizational unit's (MOU) payroll. These were started in response to many problems in a particular MOU's payroll. These audits expanded to all MOUs. Those MOUs that typically have few or no problems are not audited as often as other MOUs. The MOUs selected for an HR audit are required to submit time sheets for a particular pay period. Time sheets are audited for such things as compliance with FLSA (Fair Labor Standards Act), compliance with labor union agreements, proper approval signatures, and mathematical accuracy.

A number of years ago, Human Resources initiated mandatory direct deposit of payroll for both permanent and temporary employees. The benefits to the City of direct deposit include:

- The City improves internal control by not handling negotiable checks.
- The City saves money by not having to perform the check-printing and signing process. Payroll checks cost an average of \$1.07 to process compared to about 5 cents for direct deposit. These cost estimates are from the American Bankers Association.
- Less expensive paper stock can be used for direct deposit notifications (some employees receive electronic notification) compared to the paper stock required for paychecks.
- City bank statement reconciliations are simplified because there are no outstanding payroll checks that have not cleared the bank.
- The possibility of paycheck fraud (forged or altered checks) is reduced.

The benefits of direct deposit to employees include:

- No lost paychecks.
- Their pay is in their bank account automatically on payday-no standing in line at the bank to make a deposit.

In summary, direct deposit saves the City money and is secure and convenient for employees.

RESULTS

Internal controls are working effectively to mitigate the risks of payroll.

We had one audit finding in this audit. Management initiated corrective action before the conclusion of the audit. The audit finding is on page four of this report.

Employees are bona fide (no ghosts)

“Payroll ghosts” is an auditor term referring to employees on the payroll who are not legitimate employees. These ghosts could be real people who don’t actually work for the organization or fictitious people created for the purpose of defrauding the organization. A ghost could be a recently departed employee. It could be a friend or relative of the fraudster. The accomplice could deposit the proceeds into his or her account and share the profit with the fraudster.

We performed four audit tests to identify possible ghosts. For example, a standard audit technique is to examine the payroll data using data extraction software and identify any pay without deductions for taxes or Social Security. Completely fictitious employees frequently don’t have any. Another audit technique is to sort the payroll data with the software and look for more than one pay account going into the same bank account. We found some matches using this test. These were all legitimate situations where a married couple both worked for the City.

On the basis of our audit tests, **we found no evidence of ghosts on the City payroll.** Employees on the City payroll appear to be legitimate employees.

New hires recorded in payroll

Based on our audit work, we determined that new hires are accurately and completely recorded in the payroll system. Our audit testing included a sample of both temporary and permanent employees hired in 2007. New hires had proper hire authorizations and were placed in the approved pay grade.

Payroll data accumulated in financial records; payroll tax information reported

We determined that payroll data is completely and accurately accumulated in the City’s financial records. Additionally, federal payroll tax information reported by the City is accurate and timely. We performed detailed testing on a sample of payroll information and found it to be accurately accumulated in the general ledger. We also reviewed the records and reconciliations for federal payroll taxes. Payroll taxes are being remitted to the government on a timely and accurate basis.

Segregation of duties

In general, there is adequate segregation of duties in the payroll process. Segregation of duties is a key internal control. When duties are properly segregated, no one individual controls a transaction or process from beginning to end. Key duties in payroll processing

such as approving work hours, preparing payroll (entering time sheets into payroll system), and updating the personnel master file are segregated.

Audit finding

However, based upon discussions with Human Resources staff and with individual pay clerks, we found that pay clerks enter their own time sheets after receiving the approved (signed) time sheets back from their supervisor. Employees should not have access to their time sheets after they hand them into their supervisor for approval. The possibility exists that the employee would be in a position to alter their time worked for their own benefit. We found no evidence that this had occurred. But if this practice were allowed to continue, the possibility would exist for time sheet manipulation. We discussed this situation with HR management during the course of this audit. Management developed and implemented a control to mitigate this risk before the audit was complete. **We consider this audit issue to be resolved and commend management for their prompt action.**

Controls over printing paper checks

A very small number of paper payroll checks are prepared. Paper checks are issued to temporary employees who do not have a bank account. Paper checks are prepared for employees to correct a mistake on their regular direct deposit pay. Also, when an employee first signs up for direct deposit, a “pre-note” is sent to their bank as a sort of practice run to make sure the direct deposit information is correct before money will be transferred. For the pay period that the pre-note is done, a paper check will be issued to the employee.

We reviewed the various controls over paper payroll check processing. The controls over the process of printing paper checks are adequate and functioning properly.

Employees ending their employment

We determined that employees ending their employment were properly recorded and processed in the payroll system. We examined a sample of both permanent and temporary employees that ended their employment with the City in 2007. The final pay was properly approved and calculated correctly. Employees were not receiving pay for work after their ending date and their final pay was processed timely.

Payroll information properly secured

Payroll and employee information (both in electronic and manual form) is properly secured and access is restricted to the appropriate personnel. We verified this by observation, interviews with staff, and by reviewing written policies and procedures. Electronic payroll information is backed up on a routine basis and the City uses off-site storage for these backed-up files. The process of retrieving such electronic information has been tested and does work. Access to employee files and payroll information is properly restricted and there are physical controls in place.

Several years ago, the City began assigning four-digit employee ID numbers. These numbers are now used instead of social security numbers on such things as payroll time

sheets and employees' insurance cards. Use of employee ID numbers reduces the opportunities for identity theft using social security numbers.