

**Internal Controls for  
School Districts - Payroll**

by David Howell  
Assistant County Audit Director  
Examiners of Public Accounts  
February 9, 2016

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- This information was presented to the AASBO Payroll/Personnel Certificate Program on February 11, 2019.
- This presentation represents the audit position of the Department of Examiners of Public Accounts as of that date.

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**Examiners of Public Accounts**

- Facebook page - Alabama Department of Examiners of Public Accounts
- Twitter – follow us @Examiners3

“Fraud Hotline” to report fraud, waste or abuse:

- 1-844 56F-RAUD (1-844-563-7283)
- report.fraud@examiners.Alabama.gov

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Contact us if you have questions:  
334 242-9200

- Ashli Page, Assistant County Audit Director
- Email: Ashli.Page@examiners.alabama.gov
- Baldwin, Bullock, Butler, Clarke, Coffee, Conecuh, Covington, Crenshaw, Dale, Escambia, Geneva, Greene, Henry, Houston, Lamar, Mobile, Monroe, Pickens, Pike, Sumter, Tuscaloosa, Washington, Wilcox

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Contact us if you have questions:  
334 242-9200

- Kathy Wren, Assistant County Audit Director
- Email: Kathy.Wren@examiners.alabama.gov
- Blount, Calhoun, Cherokee, Clay, Cleburne, Coosa, Cullman, Colbert, DeKalb, Etowah, Franklin, Jackson, Jefferson,

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Contact us if you have questions:  
334 242-9200

- Kathy Wren, Continued

Lauderdale, Lawrence, Limestone, Madison, Marion, Marshall, Monroe, Morgan, Randolph, Shelby, St. Clair, Talladega, Tallapoosa, Walker, Winston

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Contact us if you have questions:  
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- Autauga, Barbour, Bibb, Chambers, Chilton, Choctaw, Dallas, Elmore, Hale, Lee, Lowndes, Macon, Marengo, Montgomery, Perry, Russell

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### Payroll Controls

Payroll and related employee benefit costs are by far the largest component of nearly every local government budget.

- Internal controls provide assurance that the large volume of information required for every payroll is processed quickly and accurately.
- The establishment of strong internal controls over payroll ensures that employees are paid the correct salary and wages, and opportunities for payroll errors and fraud are controlled. (You can't always prevent errors or fraud, but you want to be able to detect and correct the issues in a timely manner.)

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### Payroll Controls

Some examples of payroll frauds include:

- Ghost employees (someone receiving a paycheck who does not actually work for the local government);
- Overstating regular or overtime hours worked;
- Increasing rates of pay without board approval;
- Continuing employees on the payroll after termination;
- Charging employee costs to an inappropriate cost center.
- Procuring contract services without competitive bidding, where required

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## Payroll Controls

- Thought for the day:
- I would never be so presumptuous or naïve as to think we have caught nearly every auditee that committed fraud; but I can honestly say that we've never caught anyone who, when it was all said and done, that thought the risk was worth the reward.

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## Federal Audit Issues

- OMB's New "**Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards**"
- [http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title02/2cfr200\\_main\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title02/2cfr200_main_02.tpl)
- 2 CFR 200 Frequently Asked Questions (FAQ) (9/30/15)
- <https://cfo.gov/wp-content/uploads/2015/09/9.9.15-Frequently-Asked-Questions.pdf>

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## Federal Audit Issues

- **OMB Circular A-133 - Audits of States, Local Governments, and Non-Profit Organizations**
- Provides program specific guidelines for federal grants
- [https://www.whitehouse.gov/omb/circulars/a133\\_compliance\\_supplement\\_2015](https://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2015)
- GAO's "Standards for Internal Control in the Federal Government" aka the "Green Book".
- Required for federal agencies, suggested for non-federal
- Provides "best practices" for recipients of federal grants
- <http://www.gao.gov/greenbook/overview>

You must have controls in place to ensure compliance with Federal program requirements, including payroll/personnel costs.

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**Federal Payroll**

- **\$200.413 Direct costs**
- (c) The salaries of administrative and clerical staff should normally be treated as indirect (F&A) costs. Direct charging of these costs may be appropriate only if all of the following conditions are met:
  - (1) Administrative or clerical services are integral to a project or activity;
  - (2) Individuals involved can be specifically identified with the project or activity;
  - (3) Such costs are explicitly included in the budget or have the prior written approval of the Federal awarding agency; and
  - (4) The costs are not also recovered as indirect costs.

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**200.430 Compensation – personal services**

- **(i) Standards for Documentation of Personnel Expenses**
- (1) Charges to Federal awards for salaries and wages must be based on records that accurately reflect the work performed. These records **must**:
  - (i) Be supported by a system of internal control which provides reasonable assurance that the charges are accurate, allowable, and properly allocated;
  - (ii) Be incorporated into the official records of the non-Federal entity;
  - (iii) Reasonably reflect the total activity for which the employee is compensated by the non-Federal entity, not exceeding 100% of compensated activities
  - (iv) Encompass both federally assisted and all other activities compensated by the non-Federal entity on an integrated basis, but may include the use of subsidiary records as defined in the non-Federal entity's written policy;

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**200.430 Compensation – personal services**

- (v) Comply with the established accounting policies and practices of the non-Federal entity
- (vi) [Reserved]
- (vii) Support the distribution of the employee's salary or wages among specific activities or cost objectives if the employee works on more than one Federal award; a Federal award and non-Federal award; an indirect cost activity and a direct cost activity; two or more indirect activities which are allocated using different allocation bases; or an unallowable activity and a direct or indirect cost activity.
- (viii) Budget estimates (i.e., estimates determined before the services are performed) alone do not qualify as support for charges to Federal awards, but may be used for interim accounting purposes, subject to certain qualifications.

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**Example: Recent Federal Finding**

**Criteria:** Title 2 U. S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Costs Principles, and Audit Requirements for Federal Awards (Uniform Guidance)* requires the Board to use specific methods of procurement. The *Uniform Guidance*, Section 200.320, requires small purchase procedures to be used for securing services, supplies or other property for amounts that exceed the micropurchase threshold (\$3,000.00) but do not exceed the simplified acquisition threshold (\$150,000.00) by obtaining quotations from an adequate number of qualified sources.

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**Example: Recent Federal Finding**

**(Continued)**

Sealed bids or competitive proposals are required for purchases of services, supplies or other property that exceed the simplified acquisition threshold.

Finally, the Board of Education adopted a policy on December 13, 2016, related to the *Uniform Guidance* for Federal Awards that requires obtaining price or rate quotes from two or more qualified sources for procurement transactions that exceed the micropurchase threshold, and proposals for professional service contracts that exceed \$150,000.00.

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**Example: Recent Federal Finding**

**Finding Continued:**

**Condition:** The Board expended funds from the Special Education Cluster for services which exceeded the small purchase threshold without obtaining quotations from an adequate number of sources. In addition, Special Education Cluster funds were expended for services which exceeded \$150,000.00 without obtaining sealed bids or competitive proposals. As a result, the Board did not follow *Uniform Guidance* Section 200.320 or its adopted policy related to the *Uniform Guidance* for Federal Awards for these transactions.

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Example: Recent Federal Finding

Questioned Costs in this matter were

\$366,984.43

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Micro-Purchase and Simplified Acquisition  
Thresholds

- MP Threshold now \$10,000.00
- SAT Threshold now \$250,000.00

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Payroll I/C – Legal Compliance

Establish Controls for Legal Compliance. For example:

- New Hire Reporting Form (Act No. 97-228)
- Form I-9
- Superintendent’s Salary (**Code**, 16-9-12) set before term (county boe)
- Act No. 2010-761 (**Code**, 17-17-5) Salary deductions may not be used for PACs or political activity.
- Beware of Appropriations Acts provisions, such as Act No. 2013-215 which provided Superintendents could get raises only upon a majority, recorded vote.

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## Consideration of Internal Controls

Let's stop a minute, and think about a few things.

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### Name some legal compliance or theft problems that could occur in the payroll area.

- An employee could write themselves extra checks.
- An employee could increase their own pay without authority.
- An employee could increase another's (friend, family, supervisor, etc.) pay without authority.
- An employee could manipulate their withholdings to increase their take home pay or so that the Board is actually paying their part of the withholdings.

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### Legal compliance or theft problems that could occur in the payroll area (continued)

- An employee could change their W-2 so that they don't have to pay the required taxes and may cause the Board to pay penalties.
- An employee could add a fictitious employee to the payroll and cash their checks or get that person to endorse the check over to them.
- An employee could get paid for work not performed.
- Management could direct an employee to cause any of the above to occur.

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**Name some financial reporting problems that can occur in the payroll area.**

- Payroll expenses could be charged to the wrong program/cost center (Would a Super pressure you?)
- Payroll and withholding expenditures could be misstated.
- The Board could have unsubstantiated payroll liabilities on the books (overstated exp/understated net position)
- The Board could have unrecorded payroll liabilities (understated exp/overstated net position)

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**Below are some questions you should ask about your system:**

- Who is supposed to be able to make changes to an individual's payroll data? Wages, time worked, withholdings, W-2 info, etc.
- What authorization are they required to have?
- How is this authorization documented?
- Is there a record of the changes made?
- Does anyone review this record of changes made to determine that the changes were made for valid reasons?

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**Questions you should ask about your system (continued):**

- Who else besides these people has the ability to change an individual's payroll data?
- If you say "Nobody", verify this by asking the IT department or just attempting to access from other areas. See what happens. If access is denied only because of a password, make sure passwords are changed regularly and that there is actual control over passwords. Ask an employee to get you access to payroll from their terminal.

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**Questions you should ask about your system (continued):**

- Who has authority to add an employee to the payroll system?
- What authorization are they required to have?
- How is this authorization documented?
- Is the authorization being received from the person that truly has the authority to approve the changes?
- If not, how does that person get their authorization? Follow up the chain of command and all steps should be documented.

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**Questions you should ask about your system (continued):**

- Does the authorization come from the person that has been given the authority to approve payroll changes by the Board? Does the Board have to approve any payroll changes?
- **Code of Alabama 1975**, Section 16-13A-8, says, "Each local board of education shall adopt procedures relating to the expenditure of funds which do not require express board approval prior to the expenditure. A local superintendent of education, subject to these policies and board-approved budget limitations, may expend funds without prior approval of the board." Does that include salary changes for your system?

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**Questions you should ask about your system (continued):**

- Does someone verify that overtime or extra pay is supported by appropriate documentation?
- How is substitute pay handled?
- Does someone compare that for every substitute being paid there should be an employee on leave?
- Is there an approved substitute list?

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**Questions you should ask about your system (continued):**

- Has the substitute been required to make a face-to-face visit with someone other than the payroll person in the central office or the principal/department head over the location where the substitute is supposed to work?
- What locations/terminals can access payroll data?
- Should those locations/terminals have access to payroll data?

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**Questions you should ask about your system (continued):**

- Is someone verifying that the payroll “zeroes out” each month? The amounts transferred from the various funds by journal entries or actual checks should equal the amounts paid out/wire transferred, taking into account any timing differences. The amounts for withholdings on payroll reports should be reconciled to the amounts billed for withholdings including retirement, insurance, etc.

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**Questions you should ask about your system (continued):**

- Is the payroll account or the account that payroll flows through reconciled by someone other than the people that have access to other payroll data? If not, does someone review and approve the reconciliation, open the bank statements to scan for unusual items, or perform some other function that could overcome the lack of segregation?

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**Questions you should ask about your system  
(continued):**

- Are the reports filed with the IRS, Retirement System and other withholding agencies and the correspondence received from them reviewed by someone independent of the payroll process?
- Correspondence concerning problems with these agencies could be covered up if it goes straight to the person creating the problem. You could just change the mail routing to solve this.

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**Questions you should ask about your system  
(continued):**

- What kind of controls do you have over the wire transfers/direct deposits related to payroll? Do they extend to outside persons attempting to divert or access the data?
- Who has the authority to make the transfers/direct deposits and how is that authority confirmed by the bank?

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**Questions you should ask about your system  
(continued):**

- Does the school principal/department head periodically review the payroll for the school/department to verify that it looks correct based on their knowledge and that the people on it are actually working at the school/department?
- Who would catch it if the principal/department head was submitting false payroll information?
- What controls do you have over the blank check stock? Are there controls over the method for putting the signatures on the checks?

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**Questions you should ask about your system (continued):**

- Who writes the checks
- Who signs the checks
- Who distributes the checks
- Who opens the bank statements
- Who reconciles the accounts

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**Case Study**

- **Finding:** An adequate system of internal control requires incorporating segregation of duties, or proper reviews when adequate segregation of duties cannot be achieved, to ensure the controls are operating effectively. Examination procedures determined that the former Administrator was able to **misappropriate at least \$753,889.21** as a result of the following internal control deficiencies:
  - Purchase orders should be approved by an authorized official prior to being issued. The Franklin County Commission's system of internal controls allowed an employee to approve a purchase order that he or she originally entered. As a result, the former Administrator entered and approved purchase orders to fictitious vendors without appropriate supervisory approval.
  - Blank check stock should be properly secured by a designated custodian who is independent of the disbursement process, and checks should not be signed without appropriate authorization. The former Administrator obtained blank check stock and generated checks payable to fictitious vendors. She then manipulated the checks to alter the name of the payee on the check to her name. Additionally, the checks were generated with an electronic signature without appropriate authorization.

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**Case Study**

- Accounting records for cash should be reconciled to bank records on a monthly basis by someone other than the person who receipts and disburses cash and/or posts transactions to the accounting records. The former Administrator receipted and disbursed cash, posted entries to the accounting records and performed bank reconciliations.
- Bank statements should be received, opened and reviewed by an authorized individual independent of the person reconciling the bank accounts. Additionally, bank reconciliations should be reviewed periodically by an authorized, independent individual. The former Administrator opened the bank statements and performed the bank reconciliations. Additionally, there was no subsequent review of the bank reconciliations by other designated individuals. As a result of the lack of supervisory review, the former Administrator was able to alter the cancelled check pages of the bank statements by removing her name as payee and inserting the fictitious vendor's name to match the accounting records and vendor activity reports. The altered bank statements were substituted for the originals in the Commission's files.

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### Generic Audit Program – Payroll

- **New Hires**
- Select a sample of New Hired employees and perform the following:
  - Verify that there is a properly approved New Hire sheet on the employee’s personnel file
  - Verify the existence of the employee (by physically meeting them or another means such as ensuring they are on the telephone list).
  - Ensure the employee information (i.e., salary, pay type, frequency) was correctly entered in the payroll system
  - Review New Hire Form and I-9

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### Generic Audit Program – Payroll

- **Ghost Employees**
- Select a sample of employees from a payroll report and verify to an independent source (e.g.: telephone listing) to ensure the employee actually exists.

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### Generic Audit Program – Payroll

- **Terminated Employee**
- Select a sample of terminated employees and verify the following:
  - The employment status was changed from ‘Active’ to “Terminated” on the payroll system in a timely manner.
  - The employee’s final payment was accurately calculated and paid in a timely manner
  - There is evidence that an Exit interview was conducted and company assets (i.e., laptop, credit card, security badge) were retrieved.

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### Generic Audit Program – Payroll

- **Salary Adjustments**
- Select a sample of payroll adjustments (including both salary and timesheet employees) from the bi-monthly payroll reports and perform the following tests:
- Verify that the source document was appropriately signed by the HR representative and the employee’s supervisor.
- Ensure the adjustment was processed accurately and in timely manner.

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### Generic Audit Program – Payroll

- **Voluntary Salary Deductions**
- Select a sample of payroll deductions (including both salary and timesheet employees) from the bi-monthly payroll reports and perform the following tests:
- Verify to the appropriate source documentation (where possible).
- Verify that the source document was appropriately signed by a HR representative (if required) and the employee.
- Ensure the deduction was accurately and completely processed.
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### Generic Audit Program – Payroll

- **Timesheets (Non-Exempt employees)**
- Select a sample of timesheet summary reports and perform the following:
- Verify timesheets (and overtime) were approved by the employee’s supervisor
- Verify that the timesheets were approved in a timely manner.

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### Generic Audit Program – Payroll

- **Physical Security of Payroll Documentation**
- By physical observation and discussions with Payroll and/or HR employees, document the security controls surrounding payroll documentation. Assess for adequacy.

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### Controls Over Disbursements

Verify that:

- Payroll checks are not distributed to employees prior to the actual pay dates.
- Undelivered payroll checks are returned directly to the chief fiscal officer or other authorized officer for safekeeping and eventual cancellation, if warranted.
- Requests for direct deposit are made in writing and kept on file for audit purposes.
- As part of the direct deposit program, require employees to pick up their payroll statement in person.
- Pay checks are distributed by a responsible employee who is not otherwise connected with any of the steps of payroll preparation.

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### Generic Audit Program – Payroll

- **System Access**
- Verify that there is adequate separation of duties between staff in the various payroll functions\* by reviewing access roles within the payroll and benefit systems and comparing to employees current position responsibilities.
- Verify that payroll system requires a logon ID and that the passwords comply to company policies or best practices
- \*i.e., payroll preparation, approval, check writing/EFT, reconciliation, etc.

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### Generic Audit Program – Payroll

- **Review of Payroll Management/Exception Reports**
- Select a sample of management reports and perform the following steps:
  - Verify payroll reports are reviewed and approved by the appropriate level of management.
  - Reports/timesheets are reviewed and approved by each manager.

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### Generic Audit Program – Payroll

- **Processing to and Monitoring of General Ledger Payroll Accounts**
- Select a sample of Payroll Account reconciliations and ensure that the reconciliations are:
  - Completed on a regular basis
  - Signed off by the preparer
  - Reviewed and signed off by an independent employee.
- Source of Generic Audit Program: AuditKnowledge.Com

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### Questions



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