

CHAPTER 10

The Why and How of Auditing Payroll

While payroll is often seen as a low-risk area, considerable losses can occur here. Knowing how to audit payroll is important. In this chapter, I'll answer questions such as, "How should I test payroll?", and, "When should I perform fraud-related payroll procedures?"

Auditing Payroll - An Overview

Payroll exceeds fifty percent of total expenses in many governments, nonprofits, and small businesses. Therefore, it is often a significant transaction area.

To assist you in understanding how to audit payroll, let me provide you with an overview of a typical payroll process.

First, understand that entities have payroll cycles (e.g., two weeks starting on Monday). Then, payments are made after the period-end (e.g., the Tuesday after the two-week period). Also, understand that most organizations have salaried and hourly employees. Salaried personnel are paid a standard amount each payroll, and hourly employees earn their wages based on time.

Second, an authorized person (e.g., department head) hires a new employee at a specified rate (e.g., \$80,000 per year).

Third, human resources assists the new-hire with the completion of payroll forms, including tax and benefit documents.

Fourth, a payroll department employee enters the approved wage in the accounting system. Also, the employee's bank account number is entered into the system (if direct deposit is used).

Fifth, employees clock in and out so that time can be recorded.

Sixth, once the payroll period is complete, a departmental supervisor reviews and approves the recorded time.

Seventh, a payroll supervisor approves the overall payroll.

Eighth, the payroll department processes payments. Direct deposit payments are made (and everyone is happy).

In this chapter, we will cover the following:

- Primary payroll assertions
- Payroll walkthroughs
- Directional risk for payroll
- Primary risks for payroll
- Common payroll control deficiencies
- Risk of material misstatement for payroll
- Substantive procedures for payroll
- Common payroll work papers

Primary Payroll Assertions

First, let's look at assertions. The primary relevant payroll assertions include:

- Completeness
- Cutoff
- Occurrence
- Classification
- Accuracy

I believe—in general—completeness and cutoff for accrued payroll liabilities and occurrence for payroll expenses are the most

important payroll assertions. When a company accrues payroll liabilities at period-end, it is asserting that they are complete and that they are recorded in the right period. Additionally, the company is saying that recorded payroll expenses are legitimate.

When a company offers defined benefit pension plans or other postretirement benefits, the classification assertion is usually relevant. The accuracy and completeness assertions are relevant with regard to amounts reflected in the financial statements and the related disclosures.

Payroll Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions. Walk transactions from the beginning (the hiring of an employee) to the end (a payroll payment and posting). And ask questions such as the following:

- Does the company have a separate payroll bank account?
- How often is payroll processed? What time period does the payroll cover? On what day is payroll paid?
- Who has the authority to hire and fire employees?
- What paperwork is required for a new employee? For a terminated employee?
- Is payroll budgeted?
- Who monitors the budget to actual reports? How often?
- Who controls payroll check stock? Where is it stored? Is it secure?
- If the company uses direct deposit, who keys the bank account numbers into the payroll system? Who can change those numbers?
- Do larger salary payments require multiple approvals?
- Who approves overtime payments?
- Who monitors compliance with payroll laws and regulations?
- Who processes payroll and how?
- Who signs checks or makes electronic payments? If physical

checks are used, are they signed electronically (as checks are printed) or physically?

- How are payroll tax payments made? How often? Who makes them?
- Who creates the year-end payroll tax documents (e.g., W-2s) and how? Who creates quarterly tax returns and how?
- What controls ensure the recording of payroll in the appropriate period?
- Are the following duties assigned to different persons:
 - Approval of payroll
 - Processing and recording payroll
 - Signing payroll checks
 - The reconciliation of related bank statements
 - Possession of processed payroll checks
 - Ability to enter or change employee bank account numbers
 - Ability to add employees to the payroll system or to remove them
- Who can add or remove employees from the payroll system? What is the process for adding and removing employees from the payroll system?
- Who can change the master pay rate file? Does the computer system provide an audit trail of those changes, including who made them?
- Who approves salary rates and how?
- Who reconciles the payroll bank statements and how often?
- Who approves bonuses?
- What benefits does the company offer? Who pays for the benefits and how? Is there a plan document? Do the accounting personnel understand the related accounting standards and requirements? What controls are used to ensure proper benefit plan accounting?
- Who reconciles the payroll withholding accounts and how often?

- Are any salaries capitalized rather than expensed?
If yes, how and why?
- Are surprise payroll audits performed? If yes, by whom?
- Does the company outsource its payroll to a service organization? If yes, does the payroll company provide a service organization control (SOC) report? What are the service organization controls? What are the complementary controls, i.e., those performed by the employing company?

Moreover, as we ask these questions, we need to inspect documents like the payroll ledger and make observations, like who signs checks or makes electronic payments.

If control weaknesses exist, we create audit procedures to respond to them. For example, during the walkthrough, if we see that one person prints and signs checks, records payments, and reconciles the bank statement, then we will plan fraud-related substantive procedures.

As we perform payroll walkthroughs, we are asking, “What can go wrong—whether intentionally or by mistake?”

When payroll fraud occurs, understatements or overstatements of payroll expense may exist. If a company desires to inflate its profit, it can—using bookkeeping tricks—understate its expenses. As reported costs go down, profits go up. On the other hand, overstatements of payroll can occur when theft is present. For example, if a payroll accountant pays himself twice, payroll expenses are higher than they should be.

Mistakes also lead to payroll misstatements. Payroll errors can occur when payroll personnel lack sufficient knowledge to carry out their duties. Additionally, misstatements occur when employees fail to perform internal control procedures such as reconciling bank statements.

Directional Risk for Payroll

Third, consider the directional risk of payroll. The directional risk for payroll is an understatement. Make sure you audit for completeness (determining that all payroll and benefits are recorded). Nevertheless, when payroll theft occurs, such as duplicate payments, overstatements can occur.

Primary Risks for Payroll

Fourth, think about the risks related to payroll.

The primary payroll risks include:

- Payroll is intentionally understated to inflate profits
- Inappropriate parties receive payments
- Employees receive duplicate payments
- Employees receive inflated payments
- Pensions and other postretirement benefits are improperly recorded or disclosed

Common Payroll Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment work.

In smaller entities, it is common to have the following control deficiencies:

- One person performs two or more of the following:
 - Approves payroll payments to employees
 - Enters time or salary rates in the payroll system
 - Signs payroll checks or makes direct deposit payments
 - Adds or removes employees from the payroll system
 - Reconciles the payroll bank account
- No one reviews and approves recorded time
- No one reviews and approves payroll before processing
- No one performs surprise audits of payroll

- Appropriate procedures for adding and removing employees are not present
- No one reviews the removal of terminated employees from payroll
- No one compares payroll expenses to budget
- Accounting personnel lack sufficient knowledge with regard to pensions and other postretirement benefits
- Pension and other postretirement benefit accounting controls are lacking

Risk of Material Misstatement for Payroll

Sixth, assess your risk of material misstatement with the information you've gathered.

In auditing payroll, the assertions that concern me the most are completeness, cutoff, and occurrence. So my risk of material misstatement for these assertions is usually moderate to high.

My response to higher risk assessments is to perform certain substantive procedures: namely, a reconciliation of payroll in the general ledger to quarterly 941s. Why? The company has an incentive to accurately file 941s since the returns are subject to audit by governmental authorities. If the 941s are correct, the reconciliation provides support for recorded payroll.

Additionally, consider the possibility of theft, such as duplicate payments or ghost employees. In a duplicate payment fraud, the thief, usually a payroll department employee, pays himself (or a friend) twice. Ghost employees exist when payroll personnel leave a terminated employee on the payroll. Why would someone in the payroll department intentionally leave a terminated employee in the payroll system? To steal the second payment. How? By changing the terminated employee's direct deposit bank account number to his own. The result? He receives two payments—his own and that of the terminated employee.

Retirement plans create additional risks of material misstatement. I often assess the classification, accuracy, and completeness assertions at high for such plans. Defined benefit and other postretirement plan accounting requirements are complex. Since the related accounting is difficult, errors can occur. Additionally, the related disclosures are challenging, and the accounting staff may not understand these requirements.

Substantive Procedures for Payroll

And finally, it's time to determine your substantive procedures in light of your identified risks.

My customary tests for auditing payroll are as follows:

- Reconcile quarterly 941s to payroll in the general ledger
- Analytically review salary expenses (see below)
- Recompute accrued payroll liability (amount recorded at period-end)
- Review payroll withholding accounts for appropriateness and vouch subsequent payments for any significant amounts
- Compare payroll expenses (including benefits) to budget or prior year balances and examine any unexplained variances
- When control weaknesses are present, design and perform procedures to address the related risks
- Compare accrued vacation to prior periods and current payroll activity
- Test pension and postretirement benefits for appropriate accounting, including disclosures

Analytical reviews of payroll could include comparing department salary expenses to total expenses and comparing the result to prior years.

Most entities do not have defined benefit plans or other postretirement benefits. But when such benefits are present, you will perform additional audit procedures such as testing census

data, reconciling information to actuarial reports, obtaining benefit plan audit reports, testing assumptions, and recomputing benefits. Also, use a current disclosure checklist to vet the related disclosures. (Potential benefit plan types are numerous, so I am providing general audit ideas.)

Payroll controls can be tested for effectiveness. If the controls are effective, then some substantive procedures may not be necessary.

In light of my risk assessment and substantive procedures, what payroll work papers do I normally include in my audit files?

Common Payroll Work Papers

My payroll work papers normally include the following:

- An understanding of payroll-related internal controls
- Risk assessment of payroll at the assertion level
- Documentation of any payroll control deficiencies
- Payroll audit program
- Accrued salaries detail at period-end
- A summary of any significant payroll withholding accounts with supporting information
- A detail of vacation payable (if material) with comparisons to prior periods
- A comparison of current period payroll expenses with prior period expenses
- Budget to actual payroll reports
- A reconciliation of payroll in the general ledger to quarterly 941s
- Fraud-related payroll work papers when needed
- Disclosure checklist
- When pension or other postretirement benefits are present, related information such as tests of census information, tests of assumptions, plan documents, and actuarial reports

Auditing Payroll - A Simple Summary

- Primary relevant payroll assertions include completeness and cutoff for accrued payroll liabilities, occurrence for payroll expenses, and completeness, accuracy, and classification for retirement plan benefits
- Perform a walkthrough of the payroll cycle by making inquiries, inspecting documents, and making observations
- The directional risk for payroll is that it is understated
- Primary risks for payroll include:
 - Payroll is intentionally understated
 - Inappropriate parties receive payments
 - Employees receive duplicate payments
 - Employees receive inflated payments
 - Pensions and other post-employment benefits are improperly recorded or disclosed
- The substantive procedures for payroll should be responsive to the identified risks. Common procedures include:
 - Reconciling 941s to payroll
 - Recomputing accrued payroll liability
 - Reviewing payroll withholding accounts for appropriateness and vouching subsequent payments for any significant amounts
 - Comparing payroll expenses (including benefits) to budget or prior year balances and examining any unexplained variances
 - When control weaknesses are present, designing and performing procedures to address the related risks
 - Comparing accrued vacation to prior periods and current payroll activity
 - Testing pension and other postretirement expenses, related balance sheet accounts, and disclosures

Now you know how to audit payroll. Next we'll turn our attention to the audit of debt.