Sarbanes Oxley and its Impact on Payroll Controls
Agenda

• SOX frame of mind
• Internal audits and controls
• Supporting documentation
Former Sen. Sarbanes

Former Rep. Oxley
The Objectives of the Scheme to Defraud

The Problem -- Enron:

- Losing huge amounts of $$
- Debt was growing
The Objectives of the Scheme to Defraud

Enron’s solution:

- Move poorly performing assets from the balance sheet
  - Use Excel spreadsheets
- Conceal poor operating performance
- Manufacture earnings through sham transactions
Enron Executives Made a fortune

- Skilling: $103 Million
- Causey: $23 Million
- Lay: $90 Million
The Result

Enron Employees Lose a Fortune

• $3 Billion in retirement funds when stock fell

• Total recovered: $150 Million
  – $17 Million for the attorneys
The Result

SEC Complaint v. Lay, Skilling and Causey

• Prison terms!
  – 24 Years = Skilling
  – 5½ Years = Causey
"I give Sarbox high scores. It promotes accountability on many levels, and its provisions make tremendous sense. Corporate whining over Section 404 has obscured and even "tainted" the salutary effects of Sarbox."
One reason that 404 has proved so costly, is that many companies simply had lousy internal controls."

Dana Hermanson, a professor of accounting at Kennesaw State University, in Georgia.
"The act has made the role of CFO even more significant than it already was. At the time we were drafting it, one school of thought held that we should punish the bad apples and let that serve as a deterrent, but by that time the damage has been done."
Five Years of Sarbanes Oxley

The goal of the law is to make sure gatekeepers act as gatekeepers and bad actors are screened out by barriers such as good internal controls and sharp audits.”

Former Sen. Paul Sarbanes
Real Life Examples of Payroll Fraud

California:

• A payroll clerk embezzled $400,000 in additional salary payments from her employer for five years.
Texas:

• An administrator responsible for payroll embezzled $250,000 over a 2½ year period.
An Environment of Poor Internal Controls

- Need for controls not recognized by management
- Poor training
- Scarce resources provided
An Environment of Poor Internal Controls

- Misplaced priorities
- Decentralization
- Change
An Environment of Poor Internal Controls

- Human error
- Management unaware of problem
- Management not monitoring ongoing process
- Management not informed
Results of Poor Controls

- Inappropriate management decisions
- Failure to monitor assets
- Business interruption
Results of Poor Controls

- Excessive operating costs
- Loss of proprietary data
- Deception, theft, and misrepresentation
Results of Poor Controls

- Improper record keeping
- Improper accounting
- Lack of compliance
Top Payroll Fraud Activities

• Ghost employees
• Overpayment scheme
• Diverting wages or payroll taxes
Top Payroll Fraud Activities

- Theft of paychecks
- Employees writing checks to themselves
- Diverting withholding
Top Payroll Fraud Activities

• Keeping former employees on the payroll
• Expense report fraud
Corporate Responsibility

- CEO and CFO personally certify and attest to the accuracy of the financial results (§302)

- Management assessment of internal control and internal control evaluation evaluation (§404)
High Level Audits

Input of data into the system:
• New hires, salary changes, terminations, etc.
High Level Audits

Input of data into the system:

• Observe the system identifying and/or rejecting incomplete data

• Observe the generation of logs and exception reports that are reviewed
High Level Audits

Input of data into the system:

• Changes to the system functionality and/or data tables

• Examine a sample of changes by tracking data
High Level Audits

Input of data into the system:

• Examine a sample of changes by tracking
  – Testing data, and
  – Management approval
Internal Control: Integrated Framework

Released Sept 17, 2007 by the Committee of Sponsoring Organizations

COSO
Internal Control: Integrated Framework
COSO defines internal control as having five components:

- Control Environment
- Risk Assessment
- Information and Communication
COSO defines internal control as having five components:

- Control Activities
- Monitoring
Internal Controls

• Internal controls no longer just have to be in place
• Internal controls effectiveness must be proven

IT’S THE LAW
Internal Controls

Internal Control is a process

• Designed to provide reasonable assurance

• Regarding the objectives in the following categories

  – Effectiveness of operations
Internal Control is a process

- Regarding the objectives in the following categories:
  - Efficiency of operations
  - Compliance with applicable laws and regulations
  - Reliability of Financial Reporting
Internal Controls

Controls are designed to:

• Detect or prevent
  – Errors, or
  – Misstatement of the financial statements
Internal Controls

Controls: Inbound Data
## Internal Controls

### Controls: Inbound Data

<table>
<thead>
<tr>
<th>Sender</th>
<th>Recipient</th>
<th>Channel</th>
<th>Data Type</th>
<th>Security</th>
<th>Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Transaction level control objectives

• To provide a reasonable assurance that:
  – Data is received from authorized sources
  – Data is recorded completely and accurately
  – Data validations
Transaction level control objectives

• Appropriate statutory and specifications are used to:
  - Calculate and process payments

• Data is processed completely and accurately

• Production of checks is complete and accurate
Payroll Transaction Level Controls

Transaction level control objectives

• Data maintained in master files is complete and accurate

• Access to check stock (e.g. authorized signatures) is restricted

• Access to digital images (e.g. authorized signatures) is restricted
Payroll Transaction Level Controls

Transaction level control objectives

• EFT payments are:
  – Complete,
  – Accurate and
• Performed in a timely manner
Transaction level control objectives

• Output reports are:
  – Complete
  – Accurate

• Distributed in accordance with specifications
User Audits

Tests performed by auditor

- Access to program and data files
- Are users on the payroll system
  - Properly approved by management,
  - Granted appropriate access rights and
  - Current employees
User Audits

Tests performed by auditor

• Examine system settings
  – Password controls and
  – Other data security settings are properly configured

• Review procedures for granting
  – “Super user”
  – Administrative access
IT Level Controls

Objectives provide a reasonable assurance

- Changes to applications
- Changes to system software and hardware
IT Level Controls

Objectives provide a reasonable assurance

• Physical access is granted only to properly authorized individuals

• Logical access to program and data are restricted
Objectives provide a reasonable assurance

• Processing is:
  – Scheduled and performed appropriately and
  – Deviations from scheduled processing are:
    • Identified, and
    • Resolved in a timely manner
IT Level Controls

Objectives provide a reasonable assurance

• Data transmissions are complete, accurate and secure

• Programs and data are:
  – Routinely backed up and
  – Retained in a secure location
Audit Checklist

Payroll Processing Biweekly Checklist

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Date Completed</th>
<th>Initials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section I: Job Data Actions and Additional Pay</td>
<td>1. All required Job Data actions have been entered into the HR System:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Hires</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Terminations</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Transfers</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Richardson</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. All required Additional Pay Actions have been entered into the HR System.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section II: Timekeeping Entry</td>
<td>1. All biweekly &quot;Application for Leave&quot; forms for the pay period have been received and approved and all timesheets for active employees have been reviewed and approved by supervisors.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Hours worked and overtime for all active employees have been entered and verified prior to the pay period deadline based on approved timesheets.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Required leave balance corrections have been entered into the HR System.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. &quot;High Exception&quot; timekeeping errors have been reviewed and resolved using the Managing Exceptions pages.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section III: Approval/Validation</td>
<td>1. The Job Data Activity Report (HRB310) has been reviewed and verified to the approved documentation. Any identified errors have been resolved.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. The Additional Pay Activity Report (HRB160) has been reviewed for accuracy and appropriate approval and entries have been approved in the HR System.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Time entered for the period has been matched to timesheets and approved in the HR System.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. The &quot;Check/Invoice Distribution Report&quot; (PAY36406) has been reviewed for accuracy and any discrepancies reported to Payroll.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. Status of Leave Reports (HRB730) has been run and verified as correct and/or corrections identified for entry during next pay period.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section IV: Reconciliation</td>
<td>1. Payroll Certifications have been completed for all employees.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. All payroll expenditures (HRB110, HRB120, and HRB130, HRB140, Schedule 4) have been reconciled to the GL.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Timesheets and other payroll documentation have been retained per policy.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-Process</td>
<td>Key Control Description</td>
<td>Rationale</td>
<td>Responsibility</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>--------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td>2.1 New Hires</td>
<td>Verify data input against source document</td>
<td>Input into the HRIS &amp; Payroll systems is verified for accuracy against the source documents used to capture the information for all newly hired employees</td>
<td>Human Resource Representative (HR Data); Payroll Representative (Payroll Data)</td>
</tr>
<tr>
<td>2.1 Manage Personnel</td>
<td>Verify data input against source document</td>
<td>Input into the payroll system is verified against the source documents used to capture the information for employees with existing data in the HRIS or Payroll systems</td>
<td>Human Resource Representative (HR Data); Payroll Representative (Payroll Data)</td>
</tr>
<tr>
<td>2.4 Master File Maintenance</td>
<td>System Administrator reviews access (system) for accuracy</td>
<td>For approved system access requests, the System Administrator will review the access granted an employee to make sure it is accurate, prior to releasing new user ID and passwords or change authorization to the user</td>
<td>System Administrator</td>
</tr>
<tr>
<td>2.5 Capture Payroll – Time (Salaried)</td>
<td>HR/Payroll reviews timesheets for reasonableness and overtime hours</td>
<td>For salaried employees, the HR or Payroll Representative reviews time for reasonableness of hours recorded, verifying management approval and capturing any approved overtime hours prior to processing</td>
<td>HR or Payroll Representative (based on organizational structure)</td>
</tr>
<tr>
<td>2.5 Capture Payroll – Time (Hourly)</td>
<td>Manager/Supervisor reviews timecards/reports and approves hours and overtime</td>
<td>The manager or supervisor receives either timecards (manual process) or payroll reports (automated) with employees work hours. They review, approve or adjust the employees’ time worked prior to forwarding to payroll</td>
<td>Manager or Supervisor (based on organizational structure)</td>
</tr>
<tr>
<td>2.5 Capture Payroll – Time (Hourly)</td>
<td>Payroll verifies the payroll system matches the time system</td>
<td>The Payroll Representative reviews the information input into the payroll system to make sure it matches the information in the timekeeping system or the time spreadsheets</td>
<td>Payroll Representative</td>
</tr>
<tr>
<td>2.5 Capture Payroll - Rewards</td>
<td>Executive Leadership approves incentive amounts</td>
<td>Incentive compensation amounts, which have been calculated by Human Resource Representative (by geographic region)</td>
<td>Executive Leadership (by geographic region)</td>
</tr>
<tr>
<td>Standardized Key Controls</td>
<td>Current Key Controls</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Hires – Verify data against source document (both HR and Payroll Manager)</td>
<td>1. Verify accuracy of Internal A Sheet Data</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Fill our Approval to Recruit Form</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. The Officer gives the employee an Appointment Letter</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. Reconciliation of payroll data with HR data</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. HR Officer verifies data entry against source documents</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>6. HR Manager reviews and authorizes New Starter Form</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7. Payroll Admin inputs employee information from New Starter Form, initials authorizing data entry</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>8. Payroll Manager verified data input against source document</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>9. Timekeeper verifies data input</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Documentation

Requires information about how transactions are (Control Structure)

• Initiated
• Recorded
• Processed
• Reported
Documentation

Documented through (flow charts)

• Narratives
• Workflow
Documentation

- Documentation for documentation’s sake will NOT prevent fraud
- Behavior must be changed
Documentation

• Narrative contains more detail
• Responsibility of control monitoring distributed appropriately
• Disaster recovery plans are documented
Narrative

• Detail must be understandable for a third party

• Reference company policies – don’t restate
Narrative

• Cross reference items that overlap with other departments
• Use “Titles” or “Departments” not names
Checks and direct deposit stock are stored in the workroom. Only employees with access to the area have access to the workroom. A processor is responsible for check and direct deposit printing, sealing and mailing.
Checks and direct deposit advices are printed, sealed, sorted and placed in locked bags for mailing in the workroom. The locked bags are sent to the mailroom for distribution.
Checks and direct deposit advices are sent overnight via UPS. Internally distributed checks and advices are sorted and mailed to the designee on each floor through inter-office mail.
Workflow

- Information should be at “higher” level than detailed narrative
  - Chart all “key controls”

- Financial processes and controls
Workflow

• Interactions among systems and financial processes
• Financial reporting processes for control reports
Develop Workflow Maps

1. Capture the events that initiate the process
2. Identify each activity that makes up the process and the sequence in which they occur
3. Identify where decision points occur
Develop Workflow Maps

4. Identify the organization, role or person responsible for each activity

5. Identify work hand-off’s from one participant to another

6. Identify the computer systems involved to support the process
7. Capture deliverables moving from activity to activity within the process

8. Describe the end of the process and its resulting deliverables

9. Rate the complexity of the process (complex processes require more control than simple ones)
Common Workflow Shapes

- Any processing function
- Decision point between 2 or more paths in the workflow
- Data that can be read - printed output
- Any type of data in the workflow
- Manual operation performed by a person

- Preparation - A modification to a process such as initializing routine or setting a
- Workflow connectors
- On page reference - cross reference items on same page
- Off page reference - cross reference item on different page

Adjustable text block to be used for notes. Height adjusts as notes are typed.
Workflow: New Hire Sub-process

2.1 New Hires
Reviewer:
Narrative: The process of adding a newly hired employee information in the Human Resource Information System including employee data, benefits, compensation and payroll information. Note: There is an assumption that there is an approved position that is being filled.

Employee
- Start
  - Employee agrees to contract or contingent offer
    - Background check required?
      - No
        - Offer rescinded
      - Yes
        - Contract required?
          - Yes
            - Conduct background check
              - Background approved?
                - Yes
                  - Employee completes form, signs contract (if applicable)
                - No
                  - End
          - No
            - End

HR/Comp/Benefits
- Conduct background check
  - Background approved?
    - Yes
      - Send employee contract & new employee forms
        - Sends employee new employee forms
      - No
        - End
    - No
      - End

Payroll
- Forward payroll related data to Payroll Administrator
  - M
    - System
      - Payroll Admin verifies input against source documents
  - D
    - Control
      - Payroll Admin updates Payroll system with payroll data

Outsourcer
- End
  - M
    - System
      - HR updates HRIS with new employee information
  - D
    - Control
      - Verify data input against source data

HR Admin receives completed forms (and contract) from employee. Converts data to internal form if necessary.
Whenever there are process changes:

• Controls must be monitored and tested
• Documentation must be updated and maintained
Change Control

Whenever there are process changes

• Auditors may “walk through” activities documented
  – Will look for gaps, risks
  – Controls will be tested
End-to-End Control Framework
Service Organizations

Organizations -- initiating, authorizing, recording or processing transactions
Third Party Assessment of Service Organizations Controls

To make its assessment of the effectiveness of Service Organization’s internal controls, management must:

• **Identify** all significant processing performed by the service organization that impacts the company’s financial reporting
To make its assessment of the effectiveness of Service Organization’s internal controls, management must:

• Statement of Auditing Standards is acceptable: SAS 70
Review

• How did we get here?
• Internal audits and controls
• Supporting documentation