

# **Audit, Business Processes and Digitalization [BL 5]**

## **Business Level II | CA Sri Lanka**

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Study Text

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## **PART B: BUSINESS PROCESSES AND INTERNAL CONTROLS**

### **B.3: Payroll Management**

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Doing business or running an organization is a series of activities/multiple activities carried out to achieve business goals/objectives. Activities carried out on 'PAYROLL or SALARIES' is one such prime series of activities carried out by almost all of the organizations as payment of salaries is one of the major activity which involves series of tasks pertaining to payment of employees' salaries.

Notes:

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### **B.3.1. The payroll system**

The payroll system should try to ensure that under-payments and over-payments of wages and salaries are avoided

Within an organization, the accounting and finance department is responsible for payment of wages and salaries to employees. One objective of a payroll system is to ensure that employees are paid for their work. Another objective of the payroll system should be to avoid under-payments and over-payments

Events that affect payroll payments include:

- New employees joining the organization
- Employees leaving the organization
- Going on or returning from sick leave or maternity leave
- Entitlement to overtime payments
- Changes to the pay and grading of employees within the organization

There are three separate but related aspects to a payroll system

- Employee master files
- Attendance records
- Payroll processing

There should be a segregation of duties between these three areas, to reduce the risk of improper payroll payments (including fraudulent payments to non-existent employees).

- ✓ It is the responsibility of the human resources department to keep employee records, and to notify the payroll officer of all relevant details.
- ✓ The payroll officer will maintain the payroll records.
- ✓ Attendance records should be the initial responsibility of the operational managers where the employees work

### **B.3.2. Employees joining and leaving the organizations**

There should be a formal procedure for approval of new employee appointments and entering new employee records on the payroll file. There should also be procedures for removing leavers from the payroll file

#### ***New employees***

When a new employee joins an organization, the human resources (HR) department must be notified. The HR department must then create a record for the employee, containing all the necessary personal details about the employee as well as the terms and conditions of their appointment.

It is then the responsibility of the HR department to notify the finance and accounting department, so that the information about the appointment can be given to the payroll officer. These details should be provided on a staff appointment form

### ***Creating a payroll record***

New employees should be entered on to the payroll system by the payroll officer when an authorized staff appointment form is received from the HR department. New payroll records should not be created until this form is received, which means that a new employee will not be paid

If wages and salaries are to be paid into the employee's bank account, the employee must provide the HR department with banking details, which the HR department passes on to the payroll officer

### ***Leavers***

When an employee announces their intention to leave, a leaver's form should be completed by their line manager. This form should then be submitted by the line manager to the HR department, which will then enter the details on the employee's record. The employee's record should then be transferred to a file for former employees

The HR department should forward a copy of the leaver's form to the payroll officer, who should remove the employee from the payroll system

### ***Risks of fraud***

There is a risk that the employee master file may be altered fraudulently so that non-existent employees are added to the file (or leavers are not removed). If this happens, the non-existent employees' wage or salary may be paid into bank accounts controlled by the individuals committing the fraud.

To reduce the risk, recent changes to the employee master file should be checked regularly against appointment letters and leavers' reports.

### **B.3.3. Payment of wages & salaries**

Information needed for payroll preparation is gathered by the HR department, which passes the information to the accounting and finance department and the payroll officer

Weekly wages are paid on a specific day of the week, such as every Thursday. Salaries are normally paid on a specified day of each month, such as the last banking day of the month.

All information relevant to the pay for an employee should be submitted to the HR department by a specific day of the week or month, and the HR department should record this information in the employee records file and submit it to the payroll officer

## **Communication between the HR department and payroll officer**

The HR department should provide the accounting and finance department with all relevant payroll details by a specific day of the week or month, giving the payroll officer sufficient time to prepare the payroll details for the period

A senior manager in the accounting and finance department should review this information provided by the HR department and approve/authorize it, before passing the details to the payroll officer to prepare the payroll

## **Changes to standing data**

All changes to standing data for an employee, such as changes to address and bank details, should be notified to the HR department, which should pass on the information to the payroll officer

### **B.3.4. Attendance records**

Attendance records should be kept. Swipe card systems and biometric devices may be used to record attendance times

Organizations use time and attendance systems to record when employees start and stop work, and the department where the work is performed. When employees are paid by the hour, it is important that accurate attendance records are maintained for each employee

Time and attendance systems ensure that:

- Individuals are paid for their time at work
- There are no over-payments, so that employees are not paid for time they have not worked
- Employees who earn a salary do not take excessive time off work

Attendance times may be recorded using:

- Swipe cards
- Biometric devices and touch screens

With swipe cards, employees swipe the card through a card reader when arriving at work each day and when leaving. The reader automatically records the time.

Biometric devices are devices that can identify individuals by means of a physical characteristic, such as a fingerprint or the employee's palm or eye. Biometric devices can be used to record the arrival and departure of employees each day. They have the added security value that the system confirms the identity of the employee

### **Invalid swipe reports**

When attendance is recorded using a swipe card system, there will be some errors in the recording of attendance times. For example, employees may forget to swipe their card through the reader when arriving at work or leaving work.

Errors in the recording system that are identified have to be corrected manually. Details of the error should be recorded on an invalid swipe report, approved by the line manager. This should provide details of the hours actually worked by the employee. These should be submitted to the HR department, for passing on to the accounting and finance department, and the payroll officer

### **Overtime**

When automated reader systems are used to record attendance, overtime hours can be identified. This may be a requirement when overtime is paid at a higher rate than normal working hours

### **B.3.5. Running the payroll**

When payroll is being prepared for payment, a payroll report should be produced, checked and authorized

Payroll procedures are carried out by an authorized payroll officer or payroll team. They are not performed by operational managers, nor by anyone in the HR department

### **Payroll report**

Before employees are paid, the payments should be formally approved and the approvals should be documented. In order to obtain the necessary approvals, a payroll report or payroll register should be generated by the payroll system. This should summarize the pay and deductions for each employee for the pay period. The information in the payroll report should be checked against the information provided by the HR department, in order to verify regular wages and salaries; additional types of pay, such as overtime, commissions and bonuses; and deductions such as income tax.

Normal working hours and overtime are regulated by the Shop and Office Act or Wages Board ordinance depending on the job category

### **Bank instructions**

When employees are paid by bank transfer, there should also be a check of instructions to the bank about payments and the details in the payroll report

When the payroll report has been approved, the payroll officer should prepare instructions for the bank to make the necessary payments by bank transfer. When the instructions for the bank have been prepared, there should be a further check to ensure that the details in the instructions to the bank match the details in the payroll report to ensure that the employee names and payment amounts are accurate

### **B.3.6. Deductions from pay**

Deductions are made from gross pay, such as deductions for income tax

A payroll system for employees operates on a pay as you earn (PAYE) system, and income tax is deducted from the gross wages or salaries. The payroll officer must therefore make the necessary deductions for tax

Pre-defined income tax tables are provided by the Inland Revenue Department, so that the amount of income tax for each employee can be determined.

Deductions are made from gross pay, such as deductions for income tax and Employees Provident Fund (EPF). Under EPF regulations, a minimum of 8% of earnings for EPF is deducted from the employee while the employer contributes 12%. Under Employees Trust Fund (ETF) regulations, an amount of 3% of total monthly earnings for ETF is contributed solely by the employer

### **B.3.7. Leave sheets**

When absence from work affects pay, such as absence on sick leave, leave sheets should be prepared and submitted to the HR department

Depending on the rules of the employer, and the employee's terms and conditions of employment, an employee may or may not be paid for periods of absence from work, for example due to sickness.

Where pay should be adjusted for leave, departments within the organization should maintain leave sheets, which should be completed by the line manager and submitted to the HR department

### **B.3.8. Payments of wages in cash**

When wages are paid in cash, it may be necessary to prepare an unclaimed wages list and use this for checking subsequent hand-outs of wages packets

Some wages may be paid in cash (banknotes and coins). This creates a security risk that wages may be stolen or given to the wrong employee

The wage packets containing the money and a pay-slip should be handed out by the line manager to the employees, who should be required to sign or initial their name on a list as evidence that they have received them

### **B.3.9. Payroll reconciliations**

Payroll details, including details of deductions from gross pay, are recorded in the bookkeeping system. A payroll reconciliation is a check that net pay to employees plus deductions equals the total of gross wages and salaries

When wages and salaries have been paid, details of gross wages, deductions and net pay should be recorded in the bookkeeping system. The accounting department records details of gross wages and salaries, net payments to employees and various deductions from pay in the respective accounts

A payroll reconciliation process should be carried out. The purpose of payroll reconciliation is to verify that:

- Employees have been properly paid
- Payroll expenses are applied to the appropriate accounts
- Tax is paid to the Inland Revenue and reported accurately

### Reconciliation of payroll and HR records

There should also be periodic reconciliations between records on the payroll file and employee records held by the HR department

Analytical review plays an important part. Comparisons should be made of the employee costs recorded compared to previous months and expectations based on known new starters, leavers, pay rises and other factors.

The table below summarizes key control objectives, controls and tests of controls relevant to the payroll function

Occurrence and existence		
Control objectives	Controls	Tests of controls
<ul style="list-style-type: none"> <li>• Payment is made only to bona fide employees of the entity.</li> </ul>	<ul style="list-style-type: none"> <li>• Segregation of duties between HR and payroll functions.</li> <li>• Personnel files held for all employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Observe and evaluate proper segregation of duties.</li> <li>• Review a sample of starters and leavers in the year to ensure correct documentation is in place.</li> </ul>
	<ul style="list-style-type: none"> <li>• Authorisation procedures for hiring, terminating, time worked, wage rates, overtime, benefits etc.</li> </ul>	<ul style="list-style-type: none"> <li>• Review and test authorisation procedures in place.</li> </ul>
	<ul style="list-style-type: none"> <li>• Any changes in employment status of employees (eg maternity, special leave etc) informed to Human Resources department.</li> </ul>	<ul style="list-style-type: none"> <li>• Review policies and procedures in place for changing status and consider whether adequate.</li> </ul>



Occurrence and existence		
Control objectives	Controls	Tests of controls
		<ul style="list-style-type: none"> <li>Review personnel files for a sample of employees whose status changed in the year.</li> </ul>
	<ul style="list-style-type: none"> <li>Use of time clocks to record time worked.</li> </ul>	<ul style="list-style-type: none"> <li>Observe employees' use of time clocks.</li> </ul>
	<ul style="list-style-type: none"> <li>Clock cards approved by supervisor.</li> </ul>	<ul style="list-style-type: none"> <li>Inspect a sample of clock cards for evidence of approval by appropriate level of management.</li> </ul>
	<ul style="list-style-type: none"> <li>Only employees with valid employee numbers are paid.</li> </ul>	<ul style="list-style-type: none"> <li>Review and test procedures for entering and removing employee numbers from the payroll master file.</li> </ul>
	<ul style="list-style-type: none"> <li>Payroll budgets in place and reviewed by management.</li> </ul>	<ul style="list-style-type: none"> <li>Review budgeting procedures.</li> </ul>
Completeness		
<ul style="list-style-type: none"> <li>All payroll costs are recorded for work done by employees.</li> </ul>	<ul style="list-style-type: none"> <li>Prenumbered clock cards in use.</li> </ul>	<ul style="list-style-type: none"> <li>Review numerical sequence of clock cards.</li> </ul>
	<ul style="list-style-type: none"> <li>Segregation of duties.</li> </ul>	<ul style="list-style-type: none"> <li>Observe and evaluate proper segregation of duties.</li> </ul>
	<ul style="list-style-type: none"> <li>Authorisation of wage cheque cashed.</li> </ul>	<p><i>If wages are paid in cash</i></p> <ul style="list-style-type: none"> <li>Attend the pay-out of wages to confirm that the official procedures are being followed.</li> </ul>

## Occurrence and existence

Control objectives	Controls	Tests of controls
	<ul style="list-style-type: none"> <li>• Custody of cash:               <ul style="list-style-type: none"> <li>– Encashment of cheque</li> <li>– Security of pay packets</li> <li>– Security of transit</li> <li>– Security and prompt banking of unclaimed wages</li> </ul> </li> <li>• Verification of identity</li> <li>• Recording of distributions</li> <li>• Preparation and authorisation of cheques and bank transfer lists</li> <li>• Comparison of cheques and bank transfer list with payroll</li> <li>• Maintenance and reconciliation of wages and salaries bank account</li> </ul>	<ul style="list-style-type: none"> <li>• Before the wages are paid compare payroll with wage packets to ensure all employees have a wage packet.</li> <li>• Examine receipts given by employees; check unclaimed wages are recorded in unclaimed wages book.</li> <li>• Observe whether any employee receives more than one wage packet.</li> <li>• Inspect the unclaimed wages book entries with the entries on the payroll to ensure they agree.</li> <li>• Check that unclaimed wages are banked regularly by inspection of bank statements and supporting documentation.</li> <li>• Inspect that unclaimed wages books to check it shows reasons why wages are unclaimed.</li> <li>• Review pattern of unclaimed wages in unclaimed wages book; variations may indicate failure to record.</li> </ul>
		<p><i>Holiday pay</i></p> <ul style="list-style-type: none"> <li>• Verify a sample of payments with the underlying records and check the calculation of the amounts paid by recalculation.</li> </ul>

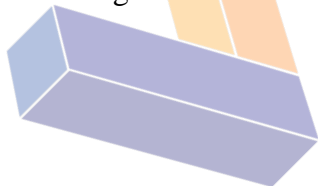
Occurrence and existence		
Control objectives	Controls	Tests of controls
		<ul style="list-style-type: none"> <li>• For salaries, review whether comparisons are being made between payment records.</li> <li>• Examine paid cheques or a certified copy of the bank list for employees paid by cheque or bank transfer.</li> </ul>
Accuracy, classification and valuation		
<ul style="list-style-type: none"> <li>• All benefits and deductions (tax, pension etc) are computed correctly.</li> </ul>	<ul style="list-style-type: none"> <li>• Verification of payroll amounts and benefit calculations.</li> </ul>	<ul style="list-style-type: none"> <li>• Recalculate benefits and deductions for a sample of employees.</li> </ul>
	<ul style="list-style-type: none"> <li>• Payroll budgets in place and reviewed by management.</li> </ul>	<ul style="list-style-type: none"> <li>• Review budgeting procedures.</li> </ul>
	<ul style="list-style-type: none"> <li>• Agreement of gross earnings and total tax deducted with taxation returns.</li> </ul>	<ul style="list-style-type: none"> <li>• Inspect documentation for evidence of management's review.</li> </ul>
<ul style="list-style-type: none"> <li>• Payroll transactions correctly recorded in the accounting system.</li> </ul>	<ul style="list-style-type: none"> <li>• Changes to master payroll file verified through 'before and after' reports.</li> </ul>	<ul style="list-style-type: none"> <li>• Review reconciliation of 'before and after' reports to payroll master file.</li> </ul>
	<ul style="list-style-type: none"> <li>• Payroll master file reconciled to general ledger.</li> </ul>	<ul style="list-style-type: none"> <li>• Review reconciliation of payroll master file to general ledger. Confirm whether discrepancies are followed-up promptly and resolved.</li> </ul>

Occurrence and existence		
Control objectives	Controls	Tests of controls
<b>Cut-off</b>		
<ul style="list-style-type: none"> <li>Payroll transactions are recorded in the correct accounting period.</li> </ul>	<ul style="list-style-type: none"> <li>All starters, leavers, changes to salaries and deductions are reported promptly to payroll department and changes are updated in the payroll master file promptly.</li> </ul>	<ul style="list-style-type: none"> <li>Review entity's procedures for reporting changes to the payroll department.</li> <li>Check sample of starters and leavers.</li> </ul>
<b>Presentation and disclosure assertions</b>		
<ul style="list-style-type: none"> <li>Payroll transactions are properly classified in the financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>Chart of accounts</li> </ul>	<ul style="list-style-type: none"> <li>Review chart of accounts.</li> </ul>
	<ul style="list-style-type: none"> <li>Independent approval and review of accounts charged to payroll.</li> </ul>	<ul style="list-style-type: none"> <li>Review procedures for classifying payroll costs.</li> </ul>
	<ul style="list-style-type: none"> <li>Payroll budgets in place and reviewed by management.</li> </ul>	<ul style="list-style-type: none"> <li>Review budgeting procedures.</li> </ul>

To summarize, the key controls over payroll cover:

- Documentation and authorization of changes
- Calculation of wages and salaries
- Payment of wages
- Authorization of deductions

All changes must be able to be tracked-back to appropriately approved source documents



### **B.3.10. Business risks in the payroll process**

The main risks in the payroll process are that employees may be overpaid, and in some cases (of fraud) non-existent employees may be paid, or former employees may continue to be paid after they have left the organization

There will also be risks of under-payment to employees, or that new employees will not be paid because they have not been added to the payroll records

#### **Risks of incorrect payroll calculations**

There are risks of errors in the process of calculating payroll. Gross pay or deductions may be calculated incorrectly. Errors should be reduced by the process of checking payroll reports before wages and salaries are paid. Computerization of payroll systems should also reduce the risk of errors in computations, such as the computation of income tax deductions

#### **Risks of incorrect information to the payroll officer**

There are also risks that the HR department will submit incorrect information to the payroll officer, or will not submit relevant information, for example may fail to provide information about new employees, leavers, changes to the pay of employees, bonuses and overtime hours



## Chapter review questions

1. When a new employee joins an organization, why are they required to provide details of pay received from their previous employer?
2. Biometric devices may be used in attendance recording systems to identify employees by means of a \_\_\_\_\_ when they arrive at and leave work each day
3. Which of the following documents is/are prepared by the HR department?
  - Invalid swipe report
  - Payroll report
  - Recruitment requisition form
  - Staff appointment form
  - Unclaimed wages report
4. A payroll reconciliation checks that:  
\_\_\_\_\_ + \_\_\_\_\_ = \_\_\_\_\_
5. An employee should notify changes in their banking details to:
  - A The HR department
  - B Their line manager
  - C The payroll officer
6. For hourly-paid employees, why is it usually necessary to record separately hours worked in normal time and hours worked in overtime?

