

Chapter 20

Audit of the Payroll and Personnel Cycle

■ Concept Checks

P. 666

1. Transactions for the payroll and personnel cycle are generally far more significant than for payroll-related balance sheet accounts because entities pay payroll related expenses throughout the year typically on a bi-weekly or monthly basis. Thus, liability accounts related to payroll generally only represent amounts associated with the last pay period, while payroll related expenses represent amounts incurred throughout the entire year.
2. The human resources department provides an independent source for the hiring and firing of personnel and the verification of wage information, including changes in wages and deductions. The primary role of the employee's primary supervisor is to verify that the hours recorded on time records were actually worked by the employee. The payroll master file is a computer file used for recording payroll transactions for each employee and maintaining total employee wages paid for the year to date.

P. 675

1. Five tests of controls that can be performed for the payroll and personnel cycle are:
 1. *Examine time card for indication of approval to ensure that payroll payments are properly authorized.* The purpose of this test is to determine that recorded payroll payments are for work actually performed by existing employees (occurrence).
 2. *Account for a sequence of payroll checks to ensure existing payroll payments are recorded.* The purpose of this test is to determine that existing payroll transactions are recorded (completeness).
 3. *Examine time cards to ensure that recorded payroll payments are for work actually performed by existing employees.* The purpose of this test is the same as in item 1 above.
 4. *Compare postings to the chart of accounts to ensure that payroll transactions are properly classified.* (Classification)
 5. *Observe when recording takes place to ensure that payroll transactions are recorded on a timely basis.* (Timing)

Concept Check, P. 675 (continued)

2. An auditor should perform audit tests primarily designed to uncover fraud in the payroll and personnel cycle when he or she has determined that internal controls are deficient (or the opportunity exists for management to override the internal controls) or when there are other reasons to suspect fraud.

■ Review Questions

20-1 General ledger accounts that are likely to be affected by the payroll and personnel cycle in most audits include the following:

Cash	Direct labor
Inventory	Salary expense
Construction in progress	Commission expense
Wages payable	Payroll tax expense
Payroll taxes withheld	
Accrued payroll taxes	

20-2 In companies where payroll is a significant portion of inventory, as in manufacturing and construction companies, the improper account classification of payroll can significantly affect asset valuation for accounts such as work in process, finished goods, and construction in process. For example, if the salaries of administrative personnel are incorrectly charged to indirect manufacturing overhead, the overhead charged to inventory on the balance sheet can be overstated. Similarly, if the indirect labor cost of individual employees is charged to specific jobs or processes, the valuation of inventory is affected if labor is improperly classified. When some jobs are billed on a cost plus basis, revenue and the valuation of inventory are both affected by improperly classifying labor to jobs.

20-3 The *Payroll Master File* is maintained for each employee indicating the gross pay for each payment period, deductions from the gross pay, the net pay, the check number, and the date. The purpose of this record is to provide detailed information for federal and state income tax purposes, and to serve as the final record of what each employee was actually paid.

The *W-2 Form* is issued to each employee at the end of each calendar year and indicates his or her gross pay, income taxes withheld, and FICA withheld for the year. In serving as a summary of the employee's earnings record, the W-2 form conveniently provides information necessary for the employee to fill out his or her income tax returns.

A *Payroll Tax Return* is the form required by and submitted to the local, state, and federal governments for the payment of withheld taxes and the employer's portion of FICA taxes and state and federal unemployment compensation taxes.

20-4 An imprest payroll account is a separate payroll bank account in which a constant balance, either zero or small, is maintained. When a payroll is paid, the exact amount of the net payroll is transferred by check or electronic funds transfer from the general account to the imprest account. The purpose and advantage of an imprest payroll account is that it limits the company's exposure to payroll fraud by limiting the amount that may be misappropriated.

20-5 Where the primary objective is to detect fraud, the auditor will examine the following supporting documents and records:

1. Cancelled payroll checks for employee name, authorized signature, and proper endorsement, watching specifically for unusual or recurring second endorsements.
2. Payroll journal or listing, tracing transactions to the personnel files to determine whether the employees were actually employed during the payroll period.
3. Payroll journal or listing and individual payroll records, selecting terminated employees to determine whether each terminated employee received his or her termination pay in accordance with company policy and whether each employee was paid in the subsequent payroll period.
4. Payroll checks, observing each employee as he or she picks up and signs for his or her check.
5. Time cards, testing them for reasonableness or observing whether they are being punched by the proper employees.

20-6 The auditor should be concerned with whether the human resources department is following the proper hiring and termination procedures. An obvious reason for this would be to ensure that there are adequate safeguards against hiring and retaining incompetent and untrustworthy people. The ramifications of hiring such people can range from simple inefficiency and waste to outright fraud or theft. More importantly, though, it is necessary for the auditor to assure himself or herself that the client is hiring and terminating according to operations standards and procedures. It is necessary to see if the internal controls are working as planned before they can be effectively evaluated. To say that the auditor doesn't care who is hired and who is fired is to suggest that he or she doesn't care if the internal controls work according to any standards. Failure to follow proper termination procedures could lead to fraudulent payments for work not performed.

20-7 To trace a random sample of prenumbered time cards to the related payroll payments in the payroll register and compare the hours worked to the hours paid is to test if payroll payments have been recorded (completeness) and if those employees who worked are being paid for their time actually worked. Employees are likely to inform management if they are not paid, or underpaid. To trace a random sample of payroll payments from the payroll register and compare the hours worked to the hours paid is to test if the recorded payroll payments are for work actually performed by existing employees

20-7 (continued)

(occurrence). This test, in effect, attempts to discover nonexistent employees or duplicate payments, if there are any. For this reason, the second procedure is typically more important to the audit of payroll.

20-8 The percentage of total audit time in the cycle devoted to performing tests of controls and substantive tests of transactions is usually far greater in the payroll and personnel cycle than for the sales and collection cycle because year-end balances in payroll-related accounts are often immaterial. Also, there is relatively little independent third-party evidence, such as confirmations, to verify the related payroll accounts. In contrast, the accounts related to the sales and collection cycle can usually be verified for the most part by confirmations from customers. In addition, in the sales and collection cycle, verification of the realizability of receivables and sales cutoff tests are important and time-consuming tasks.

20-9 Audit procedures that are primarily for the detection of fraud in the payroll and personnel cycle include:

1. Examine cancelled payroll checks for employee name, authorized signature, and proper endorsement (especially for second endorsements) to discover checks going to nonexistent employees. The endorsement should be compared to signatures on W-4 forms.
2. Trace selected transactions recorded in the payroll journal or listing to the human resources department files to determine whether the employees were actually employed during the period.
3. Select several terminated employees from payroll records to determine whether each former employee received his or her termination pay in accordance with company policy and to determine that the employee's pay was discontinued on the date of termination.
4. Examine the subsequent payroll periods of terminated employees to ascertain that the employees are no longer being paid.
5. Request a surprise payroll payoff to observe if any unclaimed checks result, which will necessitate extensive investigation.

20-10 The auditor can use audit software for tests of controls in the payroll cycle by accounting for the numerical sequence of payroll checks or other documents, testing for proper approval of time records if the client uses an electronic system to record and approve employee hours worked, or to compare dates of hiring and termination to pay periods to ensure employees are not paid subsequent to their termination date. The auditor can use audit software to perform substantive tests of transactions such as recompute net pay based on gross pay and deductions for employees, recompute total hours worked from the time records, foot the payroll journal for comparison to the general ledger, or summarize payroll by job or by category.

20-11 Types of authorizations in the payroll and personnel cycle are:

1. Deduction authorization, without which the wrong amount (or no deduction) may be deducted from the employee's paycheck.
2. Rate authorizations, without which the employee may be getting paid at the wrong rate.
3. Time card authorization, without which the employee may be getting paid for the wrong quantity of hours worked.
4. Payroll check authorization, without which unauthorized funds may be paid out.
5. Commission rate authorization, without which the salespeople might be improperly compensated for their sales efforts.
6. Authorization to hire a new employee, without which nonexistent or unqualified personnel may be added to the payroll.

20-12 Attributes sampling can be used in the payroll and personnel cycle in performing tests of controls and substantive tests of transactions with the following objectives:

1. Time card hours agree with payroll computations.
2. Overtime hours are approved.
3. Foreman approves all time cards.
4. Hourly rates agree with personnel files and union contracts.
5. Gross pay calculation is verified.
6. Exemptions taken agree with W-4.
7. Income tax, other deductions, and net pay calculations are verified.
8. Authorizations are available for voluntary withholdings and miscellaneous deductions.
9. Paycheck endorsement is same as signature on W-4 form.

The frequency of control deviations or monetary errors must be estimated prior to performing the tests. This estimate together with the acceptable risk of overreliance (ARO) and the tolerable exception rate will enable the auditor to determine the sample size required. Once the tests are performed on the sample, evaluation of the results will indicate whether the exception rate is lower than, equal to, or higher than that anticipated. The auditor must then use his or her judgment to decide the appropriate action to take.

20-13 In auditing payroll withholding and payroll tax expense, the emphasis should normally be on evaluating the adequacy of the payroll tax return preparation procedures rather than the payroll tax liability, because a major reason for misstatements in the liability account is incorrect preparation of the returns in the past. If the preparation procedures are inadequate, and the amounts do not appear reasonable, then the auditor should expand his or her work and recompute the withholding and expense amounts to determine that the proper amount has been accrued. In addition, the auditor should consider the amount of penalties that may be assessed for inadequate withholdings and include these amounts in the accrual if they are significant.

20-14 Several analytical procedures for the payroll and personnel cycle and misstatements that might be indicated by significant fluctuations are as follows:

SUBSTANTIVE ANALYTICAL PROCEDURE	MISSTATEMENT TYPES
1. Comparison of payroll expense accounts to amounts in prior years.	Cutoff misstatements or improper amounts recorded in a period.
2. Direct labor divided by sales compared to industry standards in prior years.	Cutoff misstatements or amounts charged to improper payroll accounts.
3. Commission expense divided by sales compared to industry standards, prior years, or sales agreements.	Failure to record commission on sales, or recording the improper commission amount.
4. Payroll tax expense divided by salaries and wages compared to prior year balances adjusted for changes in the tax rate and not including officers' salaries.	Failure to record payroll taxes or recording of the improper amount.
5. Comparison of accrued payroll and payroll tax accounts to prior years.	Failure to record payroll accruals or recording improper amounts at the end of a period.
6. The percentage of labor included in work in process and finished goods inventories compared to prior years.	Use of improper labor standards, or classification misstatements.
7. Analysis of direct labor variances.	Use of improper labor standards, or classification misstatements.

20-15 It is common to verify total officers' compensation even when the tests of controls and substantive tests of transactions results in payroll are excellent because the salaries and bonuses of officers must be included in filings with the SEC and IRS (e.g., the Form 10-K Report, proxy, and the federal income tax return) and because management may be in a position to pay themselves more than the authorized amount, since the controls over the officers' payroll are typically weaker and therefore easier to override than those of the normal payroll.

The usual audit procedure used to verify the officers' compensation is to obtain the authorized salary of each officer from the minutes of the board of directors and compare it to the related earnings record.

■ Multiple Choice Questions From CPA Examinations

20-16 a. (2) b. (2) c. (3)

20-17 a. (4) b. (4) c. (4)

■ Multiple Choice Questions From Becker CPA Exam Review

20-18 a. (1) b. (3) c. (3)

■ Discussion Questions and Problems

20-19

a. TRANSACTION- RELATED AUDIT OBJECTIVE	b. TEST OF CONTROL	c. POTENTIAL MISSTATEMENT	d. SUBSTANTIVE AUDIT PROCEDURE
1. Recorded payroll transactions are stated at the proper pay rates (accuracy).	Examine authorizations in personnel files.	Employees are paid the wrong rate.	Compare rates in payroll journal or listing to rates in personnel files.
2. Hours worked are correctly recorded (accuracy).	Examine time cards and observe preparation.	Incorrect recording of time.	Randomly sample workers and trace to time cards for hours worked.
3. Recorded payroll payments are for work actually performed by existing employees (occurrence).	Examine time cards for approval.	Incorrect times are used in computing employees' pay.	Analyze payroll records of a sample of employees for reasonableness.
4. Time records are properly classified by job (classification).	Examine system of identifying jobs by number.	Direct labor is charged to wrong jobs.	Trace entries from job summaries to time cards, job cards, etc.
5. Recorded payroll checks are for work performed by existing employees (occurrence).	Observe and discuss payroll system with employees.	Payroll payments are made to nonexistent employees.	Trace payroll payments to employees to determine if employee exists.

20-19 (continued)

a. TRANSACTION-RELATED AUDIT OBJECTIVE	b. TEST OF CONTROL	c. POTENTIAL MISSTATEMENT	d. SUBSTANTIVE AUDIT PROCEDURE
6. Payments are made to actual employees (occurrence).	Observe payments and discuss with employees.	Payments are made to wrong employees.	Examine cancelled checks for endorsement, and compare to personnel file.
7. Recorded payroll transactions exist (occurrence).	Examine personnel files for termination notices.	Employees are improperly terminated and payment continues.	Compare termination dates from personnel files to date of last paycheck.
8. Existing payroll transactions are recorded (completeness).	Discuss with employees and observe reconciliation.	Bank reconciliation may be misstated to conceal a diversion of cash or a misclassification of payroll transactions.	Independently test the payroll bank account reconciliation.

20-20

a. TYPE OF TEST	b. TRANSACTION-RELATED AUDIT OBJECTIVE(S)
1. Substantive test of transactions	To determine if monthly payroll costs have been correctly allocated (accuracy).
2. Test of control	To determine if recorded payroll transactions are for work actually performed by existing employees (occurrence).
3. Substantive test of transactions	To determine if employees are paid for the hours they have worked (accuracy).
4. Substantive test of transactions	To determine if payments are made to actual employees (occurrence).
5. Substantive test of transactions	To determine if the appropriate person is paid and amount and time are correct (accuracy and timing).
6. Substantive test of transactions	To determine if the correct job is charged for labor and if the amount is recorded correctly for each job (classification and accuracy).
7. Test of control	To determine if all payroll checks are recorded (completeness).

20-21

a. RECOMMENDED CONTROL	b. SUBSTANTIVE AUDIT PROCEDURE
1. Approval of time cards by foreman and observation of use of time clock by the foreman.	Observe employees punching in—only one card per employee—to see whether any employee punches two cards (normally not an effective or practical audit procedure).
2. Paychecks distributed by someone other than the foreman.	Perform payroll payoff, requiring identification from all employees prior to payment.
3. Pay employees only for time charged to jobs. Reconcile payroll expense to amounts charged to jobs.	Compare total hours worked from payroll journal or listing to total hours worked as recorded on job cost tickets.
4. Internal verification of classification.	Trace labor distribution to supporting job input forms.
5. Payroll checks not returned to payroll clerk after signing.	Perform payoff as described in 2 above.
6. Internal verification of calculations and amounts.	Recompute federal withholding taxes and trace to employee earnings record.
7. Payroll checks are prenumbered and accounted for. Use an imprest bank account where the amount to be deposited is taken from the payroll journal or listing.	Reconcile the disbursements in the payroll journal or listing to the disbursements on the payroll bank statement.

20-22

	a. TYPE OF TEST	b. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	c. BALANCE- RELATED AUDIT OBJECTIVE(S)
1.	(4) TDB	N/A	Detail tie-in
2.	(4) TDB	N/A	Completeness
3.	(3) Substantive analytical procedure	N/A	N/A
4.	(1) Test of control; (2) STOT	Occurrence and accuracy	N/A
5.	(1) Test of control	Accuracy	N/A
6.	(1) Test of control	Accuracy	N/A
7.	(1) Test of control	Completeness	N/A
8.	(4) TDB	N/A	Accuracy
9.	(3) Substantive analytical procedure	N/A	N/A
10.	(2) STOT	Occurrence, timing, and accuracy	N/A

20-23 The audit procedures performed are not sufficient. The table below presents additional audit procedures for each of the procedures performed by Ghose, and the related audit objective the procedures would satisfy.

PROCEDURE PERFORMED	a. ADDITIONAL PROCEDURES	b. AUDIT OBJECTIVE
1.	<ul style="list-style-type: none"> Consider changes in client circumstances that might suggest fluctuations in accrual balances, such as increase in number of employees. 	<ul style="list-style-type: none"> Completeness
2.	<ul style="list-style-type: none"> Examine payroll tax form filed in subsequent period to verify amount of payroll tax accrual. 	<ul style="list-style-type: none"> Accuracy, completeness
3.	<ul style="list-style-type: none"> Compare the bonus formula with prior years. For a sample of salespersons, recompute the accrued bonus based on the formula as stated in the contract. Trace amount of accrual to cash disbursements in subsequent period. 	<ul style="list-style-type: none"> Completeness Accuracy Accuracy, completeness
4.	<ul style="list-style-type: none"> Review company policy for computing and recording vacation pay accrual. For a sample of employees, recompute accrued vacation pay based on company policy. 	<ul style="list-style-type: none"> Accuracy Accuracy

20-24 A flowchart of steps for each type of test is given below (requirements

a., b., and c.):

TESTS OF CONTROLS OR SUBSTANTIVE TESTS OF TRANSACTIONS	TESTS OF DETAILS OF BALANCES
5	9
4	8
2	6
7	3
	1

20-25

	a. INTERNAL CONTROL DEFICIENCY	b. TYPE OF MISSTATEMENT
1.	The foreman should not hire employees.	The foreman may hire unqualified employees, friends, or possibly a fictitious person to be paid through the payroll system.
2.	The foremen should not recommend wages for employees.	The foreman may provide inappropriate pay rates or pay rates that are split between an employee and the foreman.
3.	Time cards should not be left in a box that employees have access to.	Employees, including the foreman, can take extra time cards and clock in for other employees or fictitious employees.
4.	The foreman collects and approves the time cards as well as the duties described in 1-3. (Note: It is appropriate for the foreman to approve times cards if he has none of the other duties described in 1-3.)	The foreman can include fictitious time cards for check preparation.
5.	There is no internal verification of the payroll clerk's input of names or hours into the payroll system.	The payroll clerk can make mistakes entering the hours or names.

20-25 (continued)

	a. INTERNAL CONTROL DEFICIENCY	b. TYPE OF MISSTATEMENT
6.	The controller compares two output records and fails to compare the output to any input records.	The controller will not find any existing mistakes made by the payroll clerk.
7.	The foreman receives the payroll checks for distribution.	The foreman can keep checks for which he has submitted time cards for nonexistent employees.
8.	The foreman mails checks to absent employees.	Nonexistent or former employees who had someone else prepare their time cards will receive a check in the mail.
9.	The controller hires and approves wages for salaried employees and signs their checks.	The controller can submit information for a nonexistent employee, open a checking account in the person's name and receive the direct deposit. She can also submit the improper salary rate to the payroll clerk and split the payment with the employee.
10.	The controller has sole access to pay rates.	The controller can include any pay rates she desires, for herself or others, including fictitious employees and friends who will split the amounts with her.
11.	The payroll clerk can add names to the payroll records.	The payroll clerk can add fictitious names for either salaried or hourly employees. She can set up a checking account in the same manner discussed in 9.
12.	An accounting clerk does the bank reconciliation each month.	The person is unlikely to be qualified to do quality bank reconciliation and will thereby be unlikely to find the frauds included previously.

20-26

	a. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	b. CONTROL EFFECTIVE IN PREVENTING OR DETECTING MISAPPROPRIATION
1.	Accuracy (unauthorized pay rates)	Only the human resource function, which is separate from the payroll function, can change employee pay rates.
2.	Occurrence (fictitious employee)	Only the human resource function, which is separate from the payroll function, can add employees to payroll.
3.	Accuracy (fictitious hours)	All payroll hours or payroll overtime hours must be approved by the employee's supervisor.
4.	Accuracy (fictitious hours)	Approval of time records by supervisor. Require employees to sign in using personal identification.
5.	Occurrence (failure to remove a terminated employee)	Require notification of human resources on termination of employees. Surprise payroll payoff.

- c. The surprise payroll payoff is effective in detecting fictitious employees that have been placed on the payroll, or terminated employees that were not properly removed from the payroll (occurrence). If payroll is directly deposited, a surprise payoff can still be performed by requiring employees to sign for payroll stubs or other acknowledgement of payment.

20-27

DEPARTMENT	EXTENT OF INCREASE OR DECREASE IN PAYROLL EXPENSE	EXPLANATION FOR EXPECTED CHANGE IN DEPARTMENT'S PAYROLL EXPENSE
Warehouse and Shipping Department	Extensive Increase	Each online sale must be individually processed for shipment to single, stand-alone customers. The time and effort to process, package, and ship goods to each online customer will significantly increase the warehouse and shipping department payroll expense.

20-27 (continued)

DEPARTMENT	EXTENT OF INCREASE OR DECREASE IN PAYROLL EXPENSE	EXPLANATION FOR EXPECTED CHANGE IN DEPARTMENT'S PAYROLL EXPENSE
IT Department	Little Change	Because the company outsourced the creation and support of the online sales system, payroll expense would likely increase minimally (e.g., some increase would occur despite the outsourcing). However, consulting expense would be expected to increase extensively.
Accounts Receivable Department	Little to Moderate Increase	Because online sales are applied to customer credit cards, most of the collection of the receivables would be handled by the credit card agencies, not by Archer Uniform's accounts receivable department. Some increase in payroll expense may occur, if there are disputes between Archer Uniforms and the credit card agencies over the amounts processed throughout the month. Additional time may be required to reconcile the processing of cash payments by the credit card agencies and the recording of sales in Archer Uniform's financial statements.
Accounts Payable Department	Moderate Increase	Assuming total sales significantly increase due to the new online offering, the volume of inventory purchases will increase. This increase in inventory purchasing will result in an increase in vendor payments to be processed. Thus, payroll expense for the accounts payable department may increase moderately. Some efficiencies may be obtained by processing larger bulk orders in a single vendor payment. However, new products may be offered and additional vendors may be used, which in turn will increase the volume of processing required in accounts payable.
Receiving Department	Extensive Increase	Assuming total sales significantly increase due to the new online offering, the volume of inventory purchases to be received and processed into the inventory warehouse will correspondingly increase.
Executive Management	Little Change	Most of the work associated with the new online sales offerings will be the responsibility of other employees.

20-27 (continued)

DEPARTMENT	EXTENT OF INCREASE OR DECREASE IN PAYROLL EXPENSE	EXPLANATION FOR EXPECTED CHANGE IN DEPARTMENT'S PAYROLL EXPENSE
Marketing	Moderate Increase	The extent of increase in payroll expense for this department will be dependent on the amount of advertising that Archer Uniforms creates to promote its new Web site. Assuming some advertising is created, there would be a moderate increase in marketing payroll expense. Other advertising expenses may increase for ads generated through external ad agencies and through Web site ad contracts.

- 20-28** a. The compensation components for the David C. Novak, Chairman and CEO, for 2014 consists of the following:

Salary	\$ 1,450,000
Stock Awards	\$ 1,925,037
Option/SAR Awards	\$ 5,228,142
Non-equity Incentive Plan Compensation	\$ 512,720
Change in Pension Value and Nonqualified Deferred Compensation Earning	\$ 202,360
All Other Compensation	<u>\$ 689,028</u>
Total	\$10,007,287

- b. The auditor would examine the minutes of a board of directors meeting for approval of the CEO's salary, or possibly review minutes from a meeting of the compensation committee of the board of directors. This satisfies the accuracy transaction-related audit objective. If the compensation was not paid prior to year-end, the auditor would ensure a liability was recorded for the proper amount, satisfying the completeness and rights and obligations balance-related audit objectives.
- c. The auditor would examine the minutes of a board of directors meeting to review the compensation plan terms to ensure that the stock option awards and stock appreciation rights were properly authorized and that the amounts paid are in compliance with the plan terms. The auditor would then verify whether the CEO met all key targets included in the plan that would trigger the awarding of option rights. This satisfies the accuracy and occurrence transaction-related audit objectives.

20-28 (continued)

- d. The auditor would test the fair value of the stock options and the Stock Option Appreciation Rights (SARs) by examining the minutes of the board of directors meeting for approval of the SARs and the proper terms to be used in estimating fair value. To examine the fair values of the stock options and SARs on the grant date, the auditor would test the assumptions and methodologies used by the company to value the awards. According to Note 14 in the consolidated financial statements for the year ended December 27, 2014, the company estimates the fair value of each stock option and SAR award as of the date of grant using the Black-Scholes option-pricing model based on weighted average assumptions for the risk-free interest rate, expected term (in years), expected volatility, and expected dividend yield. The auditor would examine the methodology used along with these assumptions to evaluate the accuracy and reasonableness. It is likely that the auditor may use a compensation specialist to assist with the examination of the stock option and SAR computations.
- e. Presentation and disclosure audit objectives are important for stock-based compensation as this information is scrutinized by regulators, investors, analysts, and competitors. There is often criticism that top executive officers are overpaid, especially relative to other workers. In addition, companies benchmark their CEO compensation against their competitors. Overall, there is demand for this information to be disclosed in the footnotes to the financial statements as well as in proxy statements for publicly traded companies.

■ Case

- 20-29** a. Conventional forms and documents in a payroll system include the following:
- Personnel records
 - Deduction authorization forms
 - Rate authorization forms
 - Time cards and job time tickets
 - Payroll checks
 - Payroll journal or listing and labor distribution
 - Earnings record
 - W-2 form
 - Payroll tax returns

20-29 (continued)

In using the computer service center, it appears that there is no loss in documentation in substance; however, the *earnings record* is not printed out each pay period, thus, the current version is usually in *machine readable form*. (This assumes that authorization forms exist although they are not discussed in the case.) The fact that the earnings record is in machine readable form is not a problem, as long as the service bureau has adequate backup and recovery controls.

The above analysis reflects the fact that Leggett's internal controls in the payroll area are generally good. There is good segregation of duties between the president and Clark, assuming both are trustworthy, honest people. Procedures, forms, records, and reports are comprehensive and well-designed.

The only potential deficiency in internal control is that errors in details could be made by the service bureau and not necessarily be caught. It is difficult to imagine that these would be material.

b.

PAYROLL TRANSACTION-RELATED AUDIT OBJECTIVE	PROCEDURES	TYPE OF PROCEDURE
1. Recorded payroll payments are for work performed by existing employees (occurrence).	a. Observe existence of personnel files in president's care.	Test of control
	b. Observe use of time clock and control of time cards by clerk.	Test of control
	c. Examine time cards for president's approval.	Test of control
	d. Observe distribution of payroll checks by president.	Test of control
	e. Examine cancelled checks for proper endorsement.	Substantive test of transactions
	f. Compare cancelled checks with personnel records.	Substantive test of transactions
	g. Examine cancelled check for president's signature.	Test of control
2. Existing payroll transactions are recorded (completeness).	a. Account for the numerical sequence of payroll checks.	Test of control and substantive test of transactions
	b. Observe preparation of payroll bank reconciliation by president.	Test of control

20-29 (continued)

PAYROLL TRANSACTION-RELATED AUDIT OBJECTIVE	PROCEDURES	TYPE OF PROCEDURE
3. Recorded payroll transactions are for the amount of time actually worked and at the proper pay rate; withholdings are properly calculated (accuracy).	a. Observe use of time clock and control of time cards by Clark. b. Observe Clark rechecking hours. c. Recompute gross pay, deductions, and net pay. d. Trace rates and authorizations to personnel file. e. Examine payroll journal or listing for approval by Clark. f. Compare rates in payroll journal or listing with personnel files to determine that rate actually paid is authorized.	Test of control Test of control Substantive test of transactions Substantive test of transactions Test of control Substantive test of transactions
4. Payroll transactions are properly classified (classification).	a. Review chart of accounts. b. Examine payroll journal or listing for approval by Clark. c. Compare classification with chart of accounts or procedures manual.	Test of control Test of control Substantive test of transactions
5. Payroll transactions are recorded on the correct dates (timing).	a. Observe collection and processing of time cards by Clark. b. Examine payroll journal or listing for approval by Clark. c. Observe posting of ledger by Clark. d. Observe preparation of payroll bank reconciliation by president. e. Compare date of check recorded in payroll journal with date on cancelled checks and time cards.	Test of control Test of control Test of control Test of control Substantive test of transactions

20-29 (continued)

PAYROLL TRANSACTION-RELATED AUDIT OBJECTIVE	PROCEDURES	TYPE OF PROCEDURE
6. Payroll transactions are properly included in the employee earnings record; they are properly summarized (posting and summarization).	a. Observe re-adding of payroll journal or listing and posting by Clark.	Test of control
	b. Examine payroll journal or listing for approval by Clark.	Test of control
	c. Observe posting of ledger by Clark.	Test of control
	d. Trace postings from payroll journal to general ledger.	Substantive test of transactions

c. Procedures in performance format:

1. Make observations of the following activities by Mary Clark:
 - a) Control, collection, and processing of time cards.
 - b) Rechecking of hours on time cards.
 - c) Processing and approval of payroll journal or listing.
 - d) Posting of general ledger.
2. Make observations of the following activities by the president:
 - a) Maintenance of personnel files.
 - b) Approval of time cards
 - c) Signing and distribution of paychecks.
3. Make observations of the following general matters and activities:
 - a) Use of time clock by employees.
 - b) Existence and use of adequate chart of accounts.
4. Select a sample of payroll check numbers and:
 - a) Account for existence and recording of paychecks.
 - b) Examine paychecks for president's signature.
 - c) Examine checks for proper endorsement.
 - d) Compare cancelled checks with personnel records.
 - e) Compare date on check with date recorded in payroll journal or listing and on the time card.
5. Select a sample of payroll entries from the payroll journal or listing and perform the following steps:
 - a) Obtain time cards, examine for president's approval, and trace hours to payroll journal or listing.

20-29 (continued)

- b) Examine personnel files and authorization for rates and deductions.
 - c) Recompute gross pay, deductions, and net pay.
 - d) Compare account classification with chart of accounts or procedures manual.
6. Select a sample of payroll journals and perform the following steps:
- a) Examine payroll journal for approval by Clark.
 - b) Trace postings to general ledger.
- d. A sampling data sheet follows. Note that this sampling data sheet was prepared using attributes sampling. The only difference between this approach and a nonstatistical approach is the determination of sample size. Under nonstatistical sampling, students' sample sizes will vary.

DESCRIPTION OF ATTRIBUTES	PLANNED AUDIT			INITIAL SAMPLE SIZE***
	EPER*	TER**	ARO**	
1. Payroll check number accounted for	0%	5%	5%	59
	0%	4%	5%	74
2. Payroll check signed by president	1%	6%	5%	78
3. Time card approved by president	1%	6%	5%	78
4. Time card hours agree with payroll journal or listing	0%	6%	5%	49
5. Personnel file is complete	1%	4%	5%	156
6. Pay rate and deductions supported by authorization	0%	5%	5%	59
7. Gross pay, deductions, and net pay correctly computed				
* These amounts are arbitrary to complete data sheet. Information to determine actual appropriate amounts is not given in problem.				
** These amounts are judgments and are not the only acceptable amounts.				
*** Determined from attributes sampling tables.				