# TOPIC 7

# PAYROLL AND PERSONNEL CYCLE

## TOPIC OVERVIEW

With human resources and payroll departments under more pressure than ever before, a modern automated payroll solution is essential for any business. Yet many organisations are still using manual processes that can't keep pace with the demands of today's workforce and the fast-changing legal and tax environment (Fin week, 2015).

Two main types of transactions are processed through the payroll and personnel cycle, namely:

- payment to employees for services rendered (salaries and wages)
- accrual and payment of payroll-related liabilities (employee deductions such as taxes, pension fund and medical aid)

The payroll and personnel cycle includes the following classes of transactions and account balances:

| **Statement of financial position** | **Statement of comprehensive income** |
|---|---|
| Bank and cash<br><br>Accounts payable [accumulated leave, unclaimed wages, South African Revenue Services (SARS) liability, pension funds liability, medical aids liability and other] | Wages and salaries [net of employee deductions such as pay as you earn (PAYE), unemployment insurance fund (UIF), skills development levy (SDL), pension fund, medical aid and other] |

The aim of this topic is to explain the activities, functions and documents in the payroll and personnel business cycle and to apply these in practical scenarios. The risks in this cycle will be explained and internal controls applied to mitigate those risks, as well as internal control over payroll and personnel transactions in a computerised environment.

**This topic is divided into the following learning units:**

| | **Learning unit** | **Title** |
|---|---|---|
| | **7.1** | **Payroll and personnel cycle** |
| | 7.1.1 | Activities and functions in the cycle |
| | 7.1.2 | Documents used in the cycle |
| | 7.1.3 | Risks and internal control in the cycle |
| | 7.1.4 | Computerisation of the cycle |

# Learning outcomes

| Learning unit | In this topic we focus on the following learning outcomes: | Level |
|---|---|---|
| 7.1 Payroll and personnel cycle | • Describe payroll and personnel transactions by explaining the activities, functions and documents associated with these transactions. | 2 |
| | • Identify, explain and evaluate the risks associated with payroll and personnel transactions and describe and apply the internal controls that could be implemented to mitigate the risks in a non-computerised environment. | 2 |
| | • Describe and apply internal control in a computerised environment to payroll and personnel transactions. | 2 |

# LEARNING UNIT 7.1

# PAYROLL AND PERSONNEL CYCLE

# INTRODUCTION

Jackson & Stent (2014:13/2) explains that the payment of salaries and wages is an integral part of any business which results in an outflow of funds.

# 7.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

The most obvious difference between a salary and wage system is that salary systems do not have a timekeeping function; a salary is a set monthly amount regardless of the hours worked by the employee (Jackson & Stent 2014:13/29).

# STUDY

Jackson & Stent (2014:13/2–13/5)

**Note the following about the study material above:**

Sections 4 and 5 in Jackson & Stent (2014:13/3–13/5) describe a **wage system**. Apart from time keeping and the difference in payment methods (salaries are generally paid by electronic funds transfer (EFT) and wages in cash), these functions are in general also relevant for a salary system.

# STUDY

Jackson & Stent (2014:13/29)

# ACTIVITY 1

1. Explain why the payroll and personnel cycle could be especially susceptible to fraud.
2. Explain what practical arrangement companies can make with employees to avoid the risk of fraud.
3. Describe the timekeeping, payroll preparation and payout functions relevant to a **wage system** in the payroll and personnel cycle.

# FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2014:13/3-13/5)

1. Companies who pay wages in cash are susceptible to fraud due to the high risk of theft of large amounts of cash.
2. To protect the company from this risk, as well as for the personal safety of employees, a company could pay wages via electronic funds transfer (EFT) directly into employees' bank accounts.
3. The timekeeping, payroll preparation and payout functions relevant to a wage system, are described in section 5 of Jackson & Stent (2014:13/4-13/5) and are not repeated here.

**Note**: Study section 1 of Jackson & Stent (2014:13/2) again if the differences between a wage and a salary system are unclear to you.

# 7.1.2 DOCUMENTS USED IN THE CYCLE

# STUDY

Jackson & Stent (2014:13/5-13/6) Section 6

# ACTIVITY 2

The following documents or records are found in most businesses. Some are applicable to the payroll system and some are not.

1. Cash receipt
2. Payroll amendment form
3. Clock card
4. Deduction tables
5. Employment contract
6. Unclaimed wages register
7. Payslips
8. Internal purchase order
9. Payroll (wage journal)
10. Purchase journal

# REQUIRED

1. State which of the above documents or records will be found in the payroll cycle.
2. State the order in which the documents will normally occur in the payroll cycle, indicating in which function within the payroll cycle they will be used.

# FEEDBACK ON ACTIVITY 2

Reference: Jackson & Stent (2014:13/5-13/6)

1. The following documents will be found in the payroll cycle:

    1.1 Payroll amendment form
    1.2 Clock card
    1.3 Deduction tables
    1.4 Employment contract
    1.5 Unclaimed wages register
    1.6 Payslips
    1.7 Payroll (wage journal)

Note: The cash receipt is applicable to the revenue and receipts cycle, and the internal purchase order and purchase journal are used in the purchases and acquisitions cycle.

As previously stated you need to know which documents are used in the different functions and business cycles for you to be able to design internal controls appropriately.

2. The correct order in which the documents will be found and the functions within which they will be used are:

    2.1 Employment contract – personnel (human resources)
    2.2 Payroll amendment form – personnel (human resources)
    2.3 Clock card – timekeeping and payroll preparation
    2.4 Deduction tables – payroll preparation
    2.5 Unclaimed wages register – payment preparation and payout
    2.6 Payslips – Payment preparation and payout
    2.7 Payroll (wage journal) – deductions: payment and recording

Note that these functions are described in more detail in Jackson & Stent (2014:13/4-13/5)

# 7.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

Internal control procedures, the practices and guidelines a business follows to protect its resources, are especially important when recording, preparing and distributing the payroll. Having proper procedures in place protects the company's assets by reducing the risk of fraud and eliminating errors (Benge, [sa].

# STUDY

Jackson & Stent (2014:13/6–13/13)

**Note the following about the study material above:**

The **payment** of **salaries** and the appropriate internal controls for this function are not specifically discussed in the textbook. In this regard you should remember that salaries are paid either by cheque or by EFT. The normal internal controls for cheque payments therefore apply to the payment of salaries. Internal controls over EFT payments in a computerised environment will be explained and applied in section 7.1.4.

To see whether you can identify the relevant internal controls over a wage payout, do the following activity:

# ACTIVITY 3

Steelworks Ltd employs 1 000 workers who receive a weekly cash wage. You are requested to assist management in implementing **internal controls over the preparation and payout of wages**. Management is satisfied that there is sufficient internal control over the clocking of hours worked by employees and the calculation and recording of the wages payable.

# FEEDBACK ON ACTIVITY 3

Internal controls over the preparation and payout of wages are explained in detail in Jackson & Stent (2014:13/12) and are not repeated here.

**Note:** Keep in mind that these internal controls are aimed at **mitigating the risks** associated with the **preparation** and **payout** of wages. The main risks identified in your prescribed textbook are:

1. Errors or theft of cash during:
    - drawing of cash
    - making up of wage packets
    - the payout [Risks addressed in points 1 to 6 of the control procedures in Jackson & Stent (2014:13/12).]
2. Misappropriation of unclaimed wages [Risk addressed in points 7 to 11 of the control procedures in Jackson & Stent (2014:13/12)].

# ACTIVITY 4

C-Ment Ltd manufactures cement blocks and pavers. The company was started some years ago and has grown steadily to the extent that it currently employs 120 semi-skilled workers.

Internal controls have not kept up with the growth of the business and you have been asked to evaluate the current wage system. You have obtained the following information:

1. The manufacturing yard is enclosed by a large security wall. The only access to the yard is through the gate used by vehicles that deliver raw materials and collect finished products. Workers enter and exit through this gate. There is a small gate hut manned by a security guard.
2. On arriving at or leaving work, employees tick off their names on a “daily time list” entering their time of arrival or departure in the space provided. A large clock is located in the gate hut.
3. The company's administration functions, such as sales and accounting, are located in a small office block next to the manufacturing yard. The accounting section is staffed by a senior accountant, Zeb Matabane, and three clerical assistants. One of the clerical assistants, Milly Moss, is responsible for the wage function which operates as follows:

    3.1 Each working day after close of business she collects the daily time lists from the gate hut and replaces them with new lists for the following day. The completed daily time lists are filed in date order in a lever arch file. She also maintains a simple hard copy employee's file for each employee.

    3.2 The wage week runs from Thursday morning to Wednesday afternoon. On Thursday mornings Milly Moss calculates the total hours worked by each employee for the week (both normal and overtime) and enters the totals against each employee's name, on a weekly “hours summary list”. She then accesses the wage application on her computer and selects the “enter hours module”. She then captures the hours for each employee, entering the employee's staff number and hours worked from the weekly “hours summary lists”.

    3.3 Once each employee’s hours worked have been entered, Milly Moss selects the “prepare payroll” module to start processing the wages and producing the payroll. The payroll reflects employee number, name, section, gross wages, deductions and net pay. It also has a space in which the employee signs on receiving his or her pay.

    3.4 Once the payroll has been produced, Milly Moss gives it to Mo Hiten, the cash payment journal clerk, who prepares a cheque for the net amount of the pay (as well as cheques for the amounts to be paid over to SARS for PAYE, UIF etc). Mo Hiten takes the cheques to Zeb Matabane who signs them.

    3.5 The cheque for the net wages and the wage packets is then delivered to WageMaster (Pty) Ltd, a security company which cashes the cheque and makes up the wage packets from the details on the packets. Milly Moss prepares a register which reflects the cheque number, amount and number of paypackets to be collected by WageMaster (Pty) Ltd. This register is signed by a WageMaster (Pty) Ltd employee.

    3.6 On Friday morning WageMaster (Pty) Ltd returns the made-up wage packets to Milly Moss who agrees the number of paypackets to the register and signs the security company's delivery note.

3.7 The wage payout takes place at 3 pm on Fridays. At 1 pm Milly Moss leaves the wage packets and a copy of the payroll at the gate hut for collection by the supervisor. The supervisor conducts his or her own payout. He or she hands the paypacket to the employee, who must show his or her staff identity card and sign the payroll next to his or her name.

3.8 Any unclaimed wages are marked as such by the supervisor on the payroll. The unclaimed wages are taken home by the supervisor (all administration office employees finish work at 1 pm on Fridays) and handed to Milly Moss on Monday morning. She agrees the packets she has been given to the payroll and puts the packets in the safe. When the employee returns to work he or she must collect their wage packet from Milly Moss (staff identity card must be produced) and sign the payroll.

## REQUIRED:

1. **Identify** and **explain** the weaknesses in C-Ment Ltd's wage system based on the information given.

## FEEDBACK ON ACTIVITY 4

Reference: Jackson & Stent (2014:13/6–13/13)

Identification and explanation of weakness in the system of internal control over the current wage system of C-Ment Ltd:

**Points 1-2:**

**Weakness:** Controls over timekeeping are inadequate.

**Explanation:**

- There is no reliable timekeeping mechanism/clocking system, making it virtually impossible to prevent invalid hours being “clocked”.
- Workers record their own times of arrival and departure and could thus create fictitious hours.
- As the entry and exit take place through a generally used gate and are unsupervised, workers can again create fictitious hours.
- Workers could tick off the names of fellow workers who are not actually at work.
- Workers could sign in but not actually go to work and return to sign out.

- "Clocking" documentation controls are poor as there is no documentation (clock card or similar) which records the time of exit and entry of each employee independently and in permanent form.
- The clipboard bearing the daily time sheets is left unattended in the gate hut and could be lost, or tampered with, for example hours could be altered.

**Point 3**

**Weakness:** There is no separate personnel (human resources) function to ensure optimum efficiency in controlling the workforce.

**Explanation:**

- A company with a workforce of 120 requires the employment of the necessary skills in the business to deal with recruitments, dismissals, wage negotiations and labour problems in accordance with sound labour practices, and to maintain accurate and complete employee records.

**Points 3.2–3.3**

**Weakness:** Controls over the calculation of hours worked and entry into the computer are inadequate, which may result in errors in the amounts paid to employees.

**Explanation:**

- Nobody checks and authorises Milly Moss's calculation of the hours worked per the time lists, and mistakes could therefore go unnoticed.
- The supervisors do not confirm that overtime hours are valid at any stage.
- No batching system of any kind seems to be used to enhance the accuracy and completeness of entry into the computer, for example no pre-entry and post-entry control totals are calculated.
- There is no review of the payroll by an independent employee (for example one of the other administration clerks) to verify that the correct hours (normal and overtime) and wage rates have been used.

**Points 3.1–3.8**

**Weakness:** Milly Moss is responsible for incompatible functions (i.e. there is not appropriate segregation of duties):

- She initiates and controls the daily timesheets.
- She calculates and enters the hours worked.

- She creates the payroll.
- She has access to the made up wage packets.

**Explanation:**

This will enable her to steal money from the company by

- invalidly increasing the hours worked (for example adding overtime) for certain employees, or
- invalidly increasing the wage rates for certain employees

**Points 3.4 - 3.5**

**Weakness:** There are inadequate authorisation controls over the cheque for net wages.

**Explanation:**

- Zeb Matabane does not check and initial the supporting documentation, for example the payroll.
- No week-to-week reconciliation is provided to explain any fluctuations in the wages.
- There is only one signatory to the cheque which increases the risk of errors or fraud going undetected.

**Point 3.7**

**Weakness:** The supervisor and Milly Moss do not meet to effect the safe transfer of the wage packets. The wage packets are nobody's direct responsibility for a period of time and are left in an unsecure place.

**Explanation:**

- The supervisors do not check the wage packets they are taking responsibility for and acknowledge that they have done so by signing the payroll. Wage packets could be lost or stolen and nobody would be accountable.

**Point 3.7**

**Weakness:** Payouts are conducted by the supervisor without a second official being present.

**Explanation:**

- This facilitates fraud by a supervisor, particularly where the supervisor has created a fictitious employee by having a “dummy workman added” and recording hours for the dummy workman (easily done as time sheets are freely available in the gate hut).

The supervisor would simply take the fictitious employee's packet and sign the payroll.

**Point 3.8**

**Weakness:** Unclaimed wage packets are taken home by the supervisor and only handed to Milly Moss on Monday morning.

**Explanation:**

- Unclaimed wage packets should be stored in a safe and should not be taken off the premises as this increase the risk of theft and or loss.

To be able to identify weaknesses in any business cycle, you need to know which internal controls should be implemented to mitigate the risks in a perfect control environment.

## 7.1.4 COMPUTERISATION OF THE CYCLE

A company's payroll system will be a combination of manual and computerised functions and most companies make use of the packaged payroll software that has been developed to meet the needs of the company (Jackson & Stent 2014:13/16).

## STUDY

Jackson & Stent (2014:13/14 - 13/28)

## ACTIVITY 5

In section 7.1.3 we explained why internal controls over **timekeeping** in a wage system are very important. This was also illustrated by the weaknesses in the wages system of C-Ment Ltd in activity 4.

**REQUIRED:**

1. Explain what the term “biometric data” means in a computerised clocking system.
2. Describe the advantages of biometric data over an identification card or a clock card.
3. Describe the application controls that could be implemented to ensure good control over **timekeeping** in a computerised wages system.
4. Describe the application controls that could be implemented to **approve** the hours that were captured during electronic timekeeping before payroll preparation can commence.

5. Describe the application controls that could be implemented over **entering additional earnings and deductions** during the payroll preparation phase in a computerised wages system.

# FEEDBACK ON ACTIVITY 5

Reference: Jackson & Stent (2014:13/19–13/21)

1. The most common example of biometric data is an employee's fingerprint. In a system where the identification of employees to be controlled by biometric data, a finger print is stored on the system so that when the employee places his finger on the scanner, it has a set of prints against which to "match" the finger print.
2. Biometric data overcomes the weaknesses of an identification card or clock card system where an employee can swipe the card on behalf of another employee and thereby create fictitious hours worked.
3. The application controls that could be implemented to ensure good control over timekeeping in a computerised wages system are described in Jackson & Stent (2014:13/19–13/20) under the activities of **1) storing biometric data on the system; 2) employee identification and recording of hours worked**; and **3) reviewing employee attendance**.

   Note that the application controls over activities 1 and 2 are mainly access controls which are preventative in nature, whilst controls over activity 3 are detective controls such as reports produced on absent employees, late arrivals and unexplained exits from the work place.

4. Once timekeeping has been performed, the hours that were electronically captured must first be approved by the foreman **before** payroll preparation can commence.

   The application controls over the **approval of hours worked** are explained in Jackson & Stent (2014:13/21) and are not repeated here.

5. Point 1.3 in Jackson & Stent (2014:13/21) explains that alterations may be necessary to the hours initially recorded during electronic timekeeping. The payroll clerk responsible for preparing the payroll will be responsible for entering these alterations made by the foreman. The application controls over **entering additional earnings and deductions** are described in Jackson & Stent (2014:13/21–13/22) and are not repeated here.

# CONCLUSION

In this learning unit we explained and applied the activities, functions and documents of payroll and personnel transactions. The risks and internal

control in the payroll and personnel cycle were explained and applied, as well as internal control over payroll and personnel transactions in a computerised environment.

In the next topic we will explain and apply capital expenditure in the finance and investment business cycle, as well as the applicable internal controls in the cycle.