



State of North Carolina

Department of State Treasurer

RICHARD H. MOORE
TREASURER

*State and Local Government Finance Division
and the Local Government Commission*

T. VANCE HOLLOMAN
DEPUTY TREASURER

Memorandum # 1084

TO: Auditors of Local Governments and Public Authorities

FROM: Sharon Edmundson, Director, Fiscal Management

DATE: August 24, 2007

SUBJECT: Audits of Local Governments and Public Authorities – Payroll and Related Liabilities

No matter the size or structure of a local government or public authority, payroll is likely to be one of its largest expenditures and certainly a material one. Over the last several months our staff has worked with several units of local government to resolve issues with payroll, specifically with the levy of penalties and accrual of interest by the Internal Revenue Service (IRS) and the North Carolina Department of Revenue (NCDOR) on late filing, late payment, and lack of filing and/or payment of required records and taxes. The amounts of these penalties have ranged from a few thousand to several hundred thousand dollars and beyond. Sometimes the affected units are those that can least afford to pay these additional costs. For any unit we believe that payment of penalties and interest is not the best use of their funds.

Unfortunately, in many of these cases the existence of and/or the amount of the unrecorded liability was not detected in the normal course of the audit. In an effort to provide auditors with more guidance in this area and to help ensure that all payroll liabilities are recorded on every unit's financial statements, we have developed audit procedures for the payroll function that are more specific than what is currently required by generally accepted auditing standards. These tests should be particularly useful in units that lack adequate internal control structures to detect issues with the payroll function. Again, we believe that it is in both the units and the auditors' best interests to conduct these more extensive procedures in an effort to more fully disclose any payroll liabilities that may be unrecorded by the unit.

- Using the payroll records of the unit, select a sample of payroll tax deposits owed throughout the year, making sure to include deposits to the Federal as well as to the State government. Trace these deposits to the bank statements of the unit to determine that the check cleared in a reasonable amount of time from the date of deposit. If the unit is making the deposits electronically, trace the amount owed from the payroll records to the bank statements to be sure the debits to the bank accounts were processed in a reasonable amount of time. If instances are found that checks or debits did not clear or did not clear in a reasonable amount of time, a larger sample size may be needed and further investigation may be needed to determine if the unit owes a penalty.
- Perform analytical review of the amount of payroll taxes recorded by the unit as compared to total salaries. The percentage of tax to salaries should remain materially stable from one year to the next. If the amount of tax varies greatly the unit could be making payments of back taxes,

- penalties, and/or interest and recording it as part of the current payroll expense. Consider performing cutoff testing of payroll at the fiscal year end as well.
- Review the disbursements register to determine that disbursements to satisfy payroll tax liabilities are being made in accordance with the schedules required by the IRS and the NCDOR (monthly, bi-weekly, etc).
- If the unit is manually transmitting year-end forms to the Federal or State government, (W-2, W-3, 1099s, 990, NC-3, NC-5), ask for proof of mailing. If the unit is not using certified mail, return receipt requested, or FedEx, UPS or DHL commercial delivery service for these forms, strongly encourage the unit to do so to establish proof of mailing.
- Ask the party responsible for payroll if there have been any notices received from the IRS, the NCDOR, or the NCEC, or if there have been any payments made to these entities of penalties and/or interest. If there have been notices, determine if a material liability resulted from the incident in question. If there have been payments, determine if any additional liability remains.
- Ask the unit management if they are aware of any outstanding liabilities to the IRS, NCDOR or NCEC. Consider adding specific language about liabilities for penalties and interest to the management representation letter.
- For units that have an established pattern of non-compliance with tax regulations, consideration must be given to the effect of that pattern of non-compliance on the financial statements and the unit's internal control structure. Audited financial reports for units with material liabilities for penalties and interest should report as a material weakness the lack of internal controls over payroll and most likely for the unit in general in the SAS 112 letter or the Yellow Book opinion.
- For units that have paid penalties and/or interest to the IRS or the NCDOR during the year being audited, verify that a budget amendment was adopted by the Board to recognize those payments, that the payments were not charged to general payroll expenses but to general government, and that payments of these liabilities were duly pre-audited in accordance with the Statutes.
- If you determine in the course of your audit work that there are material liabilities for penalties and interest to either the IRS or the State of North Carolina, please contact our office immediately.

In summary, payroll is a material expenditure for all units of government. Failure to handle it properly can cost a unit not only in large dollar amounts but in time and damaged public relations with its citizens. Failure to record all material liabilities could cause problems for the auditor if an unqualified opinion was given. These additional audit procedures may assist in determining if the unit has recorded and disclosed all of its payroll liabilities. They also may assist you in evaluating internal control in the payroll function. If you have any questions about this memorandum please contact Dean Cunningham at (919) 807-2390 or dean.cunningham@nctreasurer.com.