NPI Guidelines - **IT PAYS TO KNOW**

Internal Payroll Audit Practices™

NATIONAL PAYROLL INSTITUTE

The National Payroll Institute's mission statement is Payroll Leadership through Advocacy and Education. The Institute is committed to providing payroll-related services to payroll professionals and their employers who need to ensure compliance with over 200 legislative requirements that impact payroll.

Our Payroll Best Practices Guidelines provide general information about selected payroll legislative and compliance issues and employment and taxation laws. It is not legal advice and should not be relied upon as a substitute for reviewing your specific situation with legal counsel.

Every effort has been made to provide accurate information; however, we advise you to seek legal counsel and advice (from a qualified lawyer) regarding your specific situation. Legal obligations will vary according to the facts and circumstances and the employment jurisdiction.

All references to legislative requirements are current at the time of publication; however, government legislation shall prevail if there are any discrepancies between the guidelines and government statutes or regulations.

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INTRODUCTION

As the authoritative source of Canadian payroll knowledge, one of the objectives of the National Payroll Institute (NPI) is to publish guidelines that payroll professionals and their employers can reference as Payroll Best Practices Guidelines.

A challenge for many payroll professionals is having their employers understand that payroll is mission-critical and requires in-depth knowledge and skills to ensure compliance.

The Payroll Best Practices Guidelines can assist organizations with preparing for a payroll audit. They can also provide benchmarking tools for designing and implementing Payroll Best Practices.

These guidelines were created by a task force of NPI staff and subject matter experts, ensuring both accuracy of the information and practicality of its application based on real-life experiences within various organizations.

The Institute would like to thank the subject matter experts for their participation in the task force and contributions to these guidelines.

Members of the Institute should direct any legislative questions pertaining to these guidelines to:

NATIONAL PAYROLL INSTITUTE

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KEYWORD SEARCH AND HYPERLINKS

When viewing any of the Institute's guidelines online, readers can search for keywords appearing within the document. For example, if information is required on a certain word or phrase, type the word or phrase in the search window (activated on most applications by pressing the "Control" and "F" keys simultaneously).

These guidelines contain **hyperlinks** within the document itself. All government forms, guides and websites discussed within the guidelines can be accessed using these hyperlinks, which were active at the time of publication.

There is a quiz at the end of the document to test your knowledge.

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INTERNAL VS. EXTERNAL AUDIT

Internal audits focus on measuring the performance of an organization and are conducted by employees of the organization or a consultant hired by the organization. Internal audit is generally performed continuously to ensure that the organization's business practices will help meet its strategic goals.

There are typically two types of **external audits** an organization may have:

- An external accounting firm conducts an audit to certify the organization's financial statements. These types of audits are usually conducted annually but may also happen quarterly. This certification is required by investors, lenders, and all publicly held businesses.
- An audit conducted by the government or other official bodies with oversight of a particular industry focused on compliance with regulatory requirements. These types of audits occur when an organization has been randomly chosen for review or if there are indications of non-compliance.

For more information on external payroll audits, please refer to the Institute's **Getting Ready for a Payroll Audit Best Practices Guidelines.**

BENEFITS OF INTERNAL AUDITS

Payroll is one of the largest single expenses of an organization. Without proper accounting controls, money could be misappropriated and false expense claims processed. For this reason, employers must intimately understand their payroll costs and know how to control and predict them.

Conducting regular internal audits will help to:

- Identify and reduce data entry errors.
- Spot calculation mistakes.
- Prevent payroll fraud.
- Validate hours paid to employees required to clock in/out.
- Ensure inactive employees are not being paid.
- Verify that statutory withholdings are accurate.
- Ensure statutory remittances are being made on time.
- Accurately account for paid or unpaid time off.
- Ensure you are compliant with employment laws (e.g., overtime pay).

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Early detection and correction of errors will benefit the organization by ensuring it is compliance-ready in case of any applicable external audit. The risk of potential fines or penalties due to non-compliance may be significantly reduced.

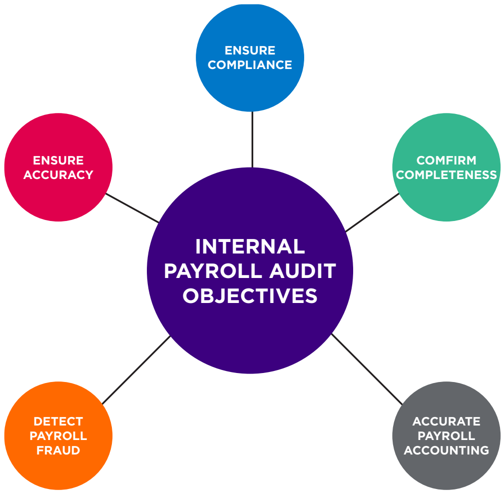
In addition to paying your employees on time and accurately, it is important to ensure that all departments follow internal rules and policies uniformly. Employees want to be treated fairly, and there should be equitable treatment at all levels of the organization.

Poor payroll practices can lead to employee turnover and harm an organization's brand and reputation. Several social media platforms are devoted to employee reviews of employers, with payroll issues among the top complaints. Regular internal audits can help reduce these risks and ensure employees feel that the organization's payroll practices are fair and professionally managed.

PURPOSE OF INTERNAL AUDITS

Internal audits evaluate a company's internal controls, including its corporate governance and accounting processes. These types of audits ensure compliance with laws and regulations and help to maintain accurate and timely financial reporting and data collection.

Additionally, internal audits provide a degree of risk management and safeguard against potential fraud, waste, or abuse.



From a payroll perspective, internal audits help an organization ensure compliance with labour laws or internal policies, verify statutory withholdings and remittances, identify errors, and prevent fraud. By conducting regular payroll audits, you can deal with these problems proactively through adjustments and corrections.

Before a qualified auditor conducts a formal compliance audit, the organization should ensure that it has well-documented workflow processes. Examining various administrative functions, establishing segregation of duties, identifying required quality checks for completeness and accuracy, and assigning responsibility to an authorized approver must be included.

Once the appropriate compliance workflows have been documented, they should be handed over to a qualified auditor to review and audit to ensure business activities are being carried out in compliance with the documented organizational processes.

An organization may have an internal audit department or contract independent accounting, security, or information technology (IT) consultants to evaluate the strength and thoroughness of their compliance measures. Auditors review security policies, user access controls, and risk management procedures throughout a compliance audit.

Upon completion of the internal review, the auditor prepares an audit summary, identifies any areas of concern, and may make recommendations such as:

- Additional compliance workflows required.
- Inaccurate or incorrectly documented workflows.
- Corrective action where workflows are not being followed.

The audit results are presented to the responsible management representative, for example, the Chief Executive Officer (CEO), for review.

ENSURE COMPLIANCE

Ensuring payroll entries are reported accurately throughout the year lowers the risk of incorrectly reporting earnings and deductions. It reduces the stress associated with preparing year-end tax slips and summaries.

Organizations must consider the legislative requirements of the Canada Revenue Agency (CRA), Revenu Quebec (RQ) and various jurisdictional requirements such as employment and labour standards legislation, workers' compensation and employer health taxes.

If they are unionized, organizations may also have policies to follow under a collective bargaining agreement (CBA). Additionally, most organizations will have unique internal policies and procedures. Internal audits will help ensure the requirements under a CBA or organizational policy are uniformly followed.

The payroll department should set up internal audit practices to test and maintain payroll controls. With changing personnel at all levels within the system, periodic testing will determine if established controls are still being met. Frequent reconciliation will also help discover possible errors that may falsify the organization's financial statements and ensure timely disclosure and correction.

A critical step of payroll control is to have internal audit reports produced and signed off each pay period. Audit reports include:

- Compare the total headcount for the current pay to the previous pay showing new hires and terminations.
- Analysis of total payroll compared to previous pay and explanation for any increases or decreases.
- Review of net pay over the set tolerance dollar amount.

If an organization is proactive, it will conduct ongoing internal audits on all processes to stay on top of any legislative changes that could alter current procedures.

Maintaining accurate and current workflows benefits the organization by ensuring the organization is compliance-ready in the event of any applicable government audit and avoiding fines or penalties due to non-compliance.

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PAYROLL CONTROLS

Here are examples of how your payroll department can develop and maintain payroll controls to reduce compliance errors.

Employee vs. Self-employed

A regular review of any individuals being paid as self-employed independent contractors should be conducted to ensure the situation remains valid. Misclassification of a worker's status is one of the most common audit issues identified by the CRA. Organizations that incorrectly identify a worker's status may be penalized for statutory deductions not withheld in addition to fines and interest.

Employment status directly affects a worker's entitlement to EI benefits under the Employment Insurance Act. It can also affect how a worker is treated under legislation such as the Canada Pension Plan and the Income Tax Act. Because of this, it is important that organizations correctly identify if a worker is an employee or a self-employed individual.

The facts of the working relationship will determine the employment status. However, the CRA and RQ generally consider an organization to be an employer if one of the following items applies to them:

- They pay their employees salaries, wages (including advances), bonuses, vacation pay, or tips.
- They provide certain taxable benefits, such as an automobile or allowances, to their employees.

For additional details on employment status, please refer to the Institute's **Employee or Self-Employed Payroll Best Practices Guidelines.**

Audit Trails

Hiring and setting employees up on payroll requires clear and established audit trail procedures. A best practice is to ensure that documentation can be traced back to the source and authorized entry. A signed and dated new-hire request from an individual with hiring authority should be provided.

The new-hire request should include the following information about the employee:

- legal name
- address
- social insurance number
- date of birth
- work location
- start date
- pay rate and hours
- status (full-time, part-time)

Authorization to hire, terminate and change the rate of pay for an employee should be given to individuals who cannot change information in the payroll system. Alternatively, an internal auditing process must be established to validate the information. Often, this is handled by Human Resources with a final sign-off from the hiring manager.

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Segregation of Duties

Even in smaller companies, no one person should be able to process a new hire form, set up the employee on payroll, and authorize that employee's payment via bank transfer or manual cheque. Appropriate access levels must be established within an organization.

Time and Attendance

All time entries for hourly paid employees, including temporary employees hired through an employment agency, must be reviewed and approved by the department manager whose budget will pay for the employee's hours. After the payroll is processed, some organizations may require the manager to sign off on the payroll register for integrity and auditing purposes.
Hours should be authorized by a supervisor or department manager and sent to payroll. Payroll should balance the hours to the time entry report or uploaded data to ensure the proper hours are paid. The process is the same whether hours are reported on time sheets or via an automated timekeeping system.

A report showing overtime as a percentage of total hours can identify departments with excessive overtime or other anomalies that need to be addressed.

Payroll data entries must be reviewed and audited by someone independent of the process pre- and post-completion. Audit trail reports should be included with payroll process backup, including the total number of hours, total employees, new hires and terminations, and any changes to pay rates, positions, and personal data. The latter must have authorized sign-off by the appropriate manager.

Employment and Labour Standards

Validation of hours processed to ensure the accurate reporting of regular and overtime hours worked in compliance with the applicable employment and labour standards legislation, collective agreement or internal company policy.

For each statutory holiday, ensure that all eligible employees have been paid and that the calculation of holiday pay is accurate.

Review vacation accrual rates to ensure they align with employment standards or the requirements under a collective agreement or internal company policy.

Verification of variable payments

Review all variable payments to ensure the required authorization was obtained. As a best practice, variable payments should be recorded separately from regular salaries and wages on the payroll register.

Some examples of variable payments included bonuses, commissions, profit-sharing and shift differentials (e.g. shift premium, acting supervisor supplement).

Classification of Employment Income

Ensure all payments to employees classified as employment income are processed through payroll.

Regularly reviewing items processed through accounts payable for employees may uncover items that should have been processed as employment income, for instance, a non-accountable car allowance or a non-cash performance reward.

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Employee Consent for Voluntary Deductions

Employees may choose to participate in voluntary programs funded through payroll deductions. For instance, an organization may run a charitable donation program allowing employees to contribute through payroll, or there may be a social club that funds events through employee contributions.

Before applying deductions to payroll, an employer must obtain an employee's consent for these types of programs.

Other Considerations

Here are a few more examples of payroll controls your organization should consider putting in place:

- Ensure the bank file for direct deposits is authorized and released by someone outside of the payroll department.
- Rotate responsibilities for different tasks regularly among the employees of a department or organization.
- Document processes and procedures to ensure compliance with company policies, employment contracts, collective agreements, and applicable federal and provincial legislation, including employment standards and the Income Tax Act.

Payroll professionals must comply with over 200 federal and provincial regulatory requirements while keeping current on constantly evolving payroll-related legislation. When effective internal controls are in place, and an internal or external auditor can validate all transactions, the likelihood of payroll fraud and its associated costs declines dramatically.

ENSURE ACCURACY

A primary goal of payroll professionals is producing accurate employee payments. Several inputs impact the accuracy of payroll calculations and reporting.

Social Insurance Number (SIN)

The SIN is a nine-digit number an individual requires to work in Canada or access certain government programs and benefits, such as Employment Insurance (EI). Payroll professionals must ensure all employees have a valid SIN attached to their payroll file.

New employees must provide their SIN to the employer within three days of starting employment. The SIN document itself is not considered an identity document. Employers should establish a process to correctly identify employees with the help of other pieces of identification, such as a driver's license or a passport.

The SIN should never be used as an employee payroll ID; however, certain government forms such as the T4 slip, RL-1 slip and the Record of Employment have a field where this number must be recorded.

Employees who provide a 900-series SIN are individuals who are neither Canadian citizens nor permanent residents but have been approved to work in Canada. These individuals should also provide their valid work permit to the employer.

A 900-series SIN has an expiration date, and employers should monitor this date and request updated documents from employees who have applied to continue working in Canada. An individual who becomes a permanent resident or Canadian citizen will be issued a regular SIN. The employee should provide the new SIN to the employer to update their payroll file.

For more details, please refer to the Institute's **Social Insurance Number Payroll Best Practices Guidelines.**

Province of Employment

Determining the province of employment for employees is essential to ensure compliance with legislation and regulations and meeting tax obligations to avoid penalties.

An employee's province of employment is either:

- The province where the employee physically reports to work at the employer's permanent or deemed establishment,
    - Including fully remote employees considered reasonably attached to an employer's establishment
- The province where the employer's business is located and from where the employer pays the employee's wages when the employee does not physically report to the employer's establishment.

Note: The employee's province of residence, although used by the government when an employee files a personal tax return, should never be assumed to be the province of employment. When an employee files a personal income tax return, the province of taxation will revert to the province where they reside on December 31 of a given taxation year.

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Employees in all jurisdictions are subject to withholding for federal income tax. However, other withholding requirements are determined based on the province of employment, including:

- CPP or QPP contributions
- EI or QPIP premiums
- Provincial or territorial income tax
- Northwest Territories or Nunavut payroll tax

An employee's province of employment will also dictate whether their earnings must be included in the calculation of any provincial employer health taxes.

A periodic review should be conducted to ensure that the province of employment for employees transferred to another jurisdiction or those moved to remote or work-from-home status is current and accurate.

For more details, please refer to the Institute's **Province of Employment Payroll Best Practices Guidelines.**

Taxable Benefits

Organizations often provide supplemental benefits to their employees. Many of these benefits are taxable, and the fair market value must be included in payroll, subject to statutory withholding. The fair market value of a taxable benefit includes all applicable sales taxes. Three jurisdictions allocate a special tax on certain types of group insurance premiums.

- Manitoba 7%
- Ontario 8%
- Quebec 9%

A periodic review of benefits being provided to employees should be conducted to ensure that the fair market value of those benefits considered taxable under the CRA or RQ are being reported through payroll.

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TD1 and TP-1015.3 Forms

A key document that impacts the calculation and withholding of federal and jurisdictional income tax is the TD1 form, or TP-1015.3 form, for Quebec employees.

All new employees of an organization should be instructed to provide completed federal and provincial TD1 forms or a federal TD1 and TP-1015.3 form for Quebec employees. Employers are advised to use the basic personal amount for the federal or jurisdictional claim when a form is not received. Employees claiming amounts in addition to the basic personal amount should also be reminded to submit new forms each year or any time during the year if their situation changes.

A suggested TD1 audit review is for employees requesting additional voluntary income tax deductions. Often, these requests are made due to the employee owing income tax when they filed their tax return, but the root cause of the income tax deficiency is an incorrect TD1 claim amount in payroll.

EXAMPLE:

Viktor has two part-time jobs and filed TD1 forms claiming the basic personal amount with each employer.

When Viktor filed the previous year's income tax return with the combined employment income, the total income tax deducted was insufficient, and an additional amount was owed.

Rather than requesting additional voluntary income tax deductions, this situation could be rectified for the current year by updating the TD1 forms and only claiming the basic personal amount with one employer.

Although completion of the TD1 and TP-1015.3 forms is the employee's responsibility, employers should conduct a basic review to ensure the reasonability and accuracy of claims. It is a serious offence for an employer to knowingly accept a form containing false or deceptive statements.

If a questionable form is received, discuss it with the employee and request an amended form. If the employer is still in doubt, refer the form to the CRA or RQ.

Statutory Withholding

Ensure the correct withholding method is applied in payroll based on the nature of the payments being processed.

- Regular pay frequency earnings are subject to periodic income tax withholding.
- Irregular payments are subject to the bonus tax method.
- Severance or retiring allowances are subject to lump-sum tax withholding.

A pay period exemption for CPP or QPP contributions should only be applied once for each pay run, based on the pay frequency. When irregular payments such as bonuses or off-cycle payroll adjustments are processed, care must be taken to ensure the C/QPP exemption is not duplicated.

The CRA's Payroll Deductions Online Calculator (PDOC) or RQ's Calculation of Source Deductions and Employer Contributions (WebRas) tools may be used to validate statutory withholding amounts.

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Reporting Payroll Earnings and Deductions

To ensure correct reporting of the organization's earnings and deductions on T4 or RL-1 slips, review the payroll set-up for all codes to ensure they have been correctly set up in the system.

Employers should check that:

- All reportable payroll codes have been mapped to report in the correct boxes.
- All earnings, allowances and taxable benefits have been set up as either pensionable, insurable or taxable based on whether it is cash, near-cash or non-cash earning type.
- Deductions that reduce taxable income, such as RPP or RRSP contributions, are correctly applied before income tax is calculated.

Most payroll software providers will generate test T4/RL-1 reports for employers to review. It is recommended that this review be done before the final pay run of the year to allow an opportunity to correct any errors or deficiencies.

CONFIRM COMPLETENESS

The other primary goal of payroll professionals is to pay employees on time. Tracking the root cause of late or incorrect payments will assist in implementing continuous improvement initiatives to avoid reoccurrence.

Payroll errors can occur for various reasons, and they can have significant consequences for employees and employers. Here are some of the most common payroll errors and their causes:

1. **Incorrect employee information:** Errors in employee data, such as name misspellings, incorrect social insurance numbers, wrong addresses, or incorrect tax withholding information, can lead to payroll mistakes.
2. **Incorrect classification of employees:** Misclassifying employees as independent contractors or vice versa can result in errors related to tax withholding, benefits, and overtime payments. It is crucial to correctly determine the employment status of workers to ensure compliance with labour laws.
3. **Mistakes in calculating hours worked:** Incorrectly recording or calculating employee work hours, including overtime, can lead to underpayment or overpayment of wages. This can occur due to manual errors, inaccurate timekeeping systems, or failure to consider different types of leave or absences.
4. **Calculation errors:** Mistakes in calculating deductions, such as taxes, insurance premiums, retirement contributions, or wage garnishments, can result in inaccurate employee net pay. These errors may arise from manual calculations, outdated tax tables, or incorrect application of statutory regulations.
5. **Missed deadlines:** Failing to meet deadlines for submitting payroll tax deposits, tax returns, or other mandatory filings can lead to penalties and interest charges. This can happen due to administrative oversight or inadequate payroll management processes.
6. **Failure to comply with labour laws:** Non-compliance with labour laws regarding minimum wage requirements, overtime pay, or leave entitlements can result in payroll errors and potential legal consequences. Lack of awareness of changing labour regulations or outdated payroll practices can contribute to such errors.
7. **System or software glitches:** Errors may occur due to glitches or malfunctions in the payroll software or payroll system. This can result in incorrect calculations, missed payments, or delayed payroll processing.

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8. **Lack of communication:** Insufficient communication between HR, payroll, and finance departments can lead to errors in payroll processing. Inaccurate employee data, missed updates, or misinterpreted information can cause payroll mistakes.
9. **Inadequate training or knowledge:** Insufficient training of payroll administrators or lack of knowledge about payroll processes, tax laws, or employment regulations can contribute to errors. Keeping payroll staff updated with training and industry changes is essential to minimize errors.
10. **Fraud or misconduct:** Intentional manipulation or fraudulent activities, such as ghost employees, falsifying hours worked, or unauthorized changes to employee data, can result in payroll errors and financial loss for the organization.

Off-cycle payments in payroll refer to payments made outside the regular payroll cycle. These payments are typically made for various reasons outside the normal payroll schedule. Here are some common reasons for off-cycle payments:

1. **New hires:** When a new employee joins the company, and their start date falls after the regular payroll cut-off, an off-cycle payment may be necessary to compensate them for the period between their start date and the next regular pay cycle.
2. **Terminations or separations:** If an employee leaves the company before the regular payroll cycle, they may be entitled to receive their final paycheck promptly. Off-cycle payments process the final wages, including unused vacation time or other applicable payouts.
3. **Correcting errors:** Off-cycle payments often rectify payroll errors or discrepancies. For example, suppose an employee was underpaid or missed a bonus or commission payment in the regular payroll. In that case, an off-cycle payment can be made to correct the mistake and ensure the employee receives the correct amount.
4. **Retroactive adjustments:** In some situations, changes need to be made to an employee's compensation or benefits retroactively. This can occur due to adjustments in salary, corrections to hours worked, changes in tax withholding status, or amendments to benefit plans. Off-cycle payments account for the retroactive adjustments and ensure the employee is paid accurately.
5. **Reimbursements:** If an employee incurs expenses that need to be reimbursed outside of the regular payroll cycle, such as travel or business-related costs, an off-cycle payment can be issued to reimburse the employee promptly.
6. **Bonus or incentive payments:** Sometimes, companies provide bonuses or incentives to employees outside of the regular payroll schedule. These additional payments may be based on individual or company performance, special projects, or other factors. Off-cycle payments are used to distribute these one-time payments.
7. **Special circumstances:** Certain situations may warrant off-cycle payments. This can include emergency or hardship situations requiring immediate financial assistance, advance payments for employees facing financial difficulties, or payments related to legal settlements or court orders.

By maintaining a log identifying errors and off-cycle pay payments, payroll professionals may be able to implement changes to reduce or eliminate some recurring issues.

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ACCURATE PAYROLL ACCOUNTING

A payroll accounting audit ensures the organization's financial records' accuracy and integrity.
Various aspects of payroll accounting are reviewed, including general ledger allocation, accruals, third-party payment, hand-written cheques, e-transfers, direct deposits to employees outside the payroll system, expense reports and government remittances.

Ensuring all financial transactions related to employee compensation are accurately recorded and accounted for is key. The primary objective of the payroll accounting audit is to verify that payroll expenses are correctly allocated in the general ledger, cost centers, branches or departments. This process may require a review of timesheets, payroll register, contracts, enrolment forms and other related expenses.

In addition, accruals related to salaries, wages, accumulated vacation time, sick time and benefits are examined, ensuring these liabilities are reported on the organization's balance sheet.

Reconciliation

Payroll reconciliation is another aspect of internal audits. Organizations can identify irregularities and inconsistencies that may require further investigation or adjustments by analyzing and comparing financial records with supporting documentation such as timesheets, tax forms, benefits enrollments, and bank statements. This process assists in detecting fraudulent activities, such as duplicate entries and unauthorized payments.

A review of accounts payable is also conducted during a payroll accounting audit to ensure all payments made on behalf of employees are completed and sent to third-party service providers. Payments to external organizations should align with payroll registers and be supported by documentation such as health benefits, pension, union enrolment forms and garnishments.

Some organizations may have employees as their customers under the accounts receivable ledger. A situation where an employee has been granted a loan or is required to repay salary or wages should be reconciled and compared to payroll registers to determine ending balances.
Frequent reconciliation can help uncover possible errors and ensure that manual and cancelled payments are processed on time. An independent person outside the payroll department should complete monthly reconciliations of bank accounts.

Accounting software is used to produce profit and loss statements, commonly produced monthly, that detail expenses by department or cost centre. Labour costs should be analyzed by the individual department heads and compared to budgets for variances.

Employee expense claims should be reviewed to validate the business-related nature of reimbursements. Items of a personal nature may need to be redirected to payroll to allocate a taxable benefit.

By applying best practices in auditing procedures and leveraging technology, organizations can accomplish accuracy in their financial reporting, avoid risks associated with incorrect and late payments, maintain integrity in payroll processes, stay compliant and safeguard the interests of employees and stakeholders.

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DETECT PAYROLL FRAUD

Payroll fraud is when someone misappropriates funds from a business utilizing the organization's payroll system. There are several methods people may use to steal funds they are not entitled to, including falsified timesheets, issuing unauthorized bonuses and paying fictitious or terminated employees.

For this reason, employers must understand their payroll costs and know how to analyze and have fraud controls in place.

The degree of controls and security implemented will depend on the following:

- The type of payroll system in use.
- The size of the organization:
    - Small organizations will typically require fewer and simpler controls than large organizations.

Fraudsters look for ways to outsmart internal controls, including organizational policies and procedures. The risk of fraud is heightened when employers become complacent about such policies.

Fraud may be committed within the payroll department, from an outside source, or in collusion with one or more persons.

An Association of Certified Fraud Examiners study shows that payroll fraud is the number one source of accounting fraud and employee theft. Payroll fraud occurs in 27% of all businesses and nearly twice as often in small organizations with less than 100 employees.

WHAT DRIVES EMPLOYEES TO COMMIT FRAUD?

The fraudster may be under financial pressure or rationalize that their theft is justified because of a sense of entitlement. They may also believe there is no chance they will be caught.

There are red flags to look for that may indicate the presence of fraud. Indicators of fraud include:

- Sudden change in lifestyle
    - Has the employee recently purchased a new property, vehicle or luxury goods? Have they taken expensive vacations? Do these purchases seem inconsistent with the employee's income or family income?
- Personal financial difficulties
    - Does the employee have debt or family pressures? Are they involved in an outside private business that may drain family finances? Is the employee going through a divorce or separation? Are they a known gambler or speculative investor? Is there a history of drug abuse?
- Refusal to seek assistance from fellow employees
    - Does the employee refuse to share certain duties or refuse to accept assistance? The employee declining a transfer that would involve losing primary access to payment processes may also be a red flag.

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- Working excessive overtime and refusing to take vacations
  - o Does the employee refuse to take their vacation time? Do they work outside of regular business hours when it seems unnecessary?
- Lack of cooperation with the internal or external auditors
- Transactions that are unsupported or recorded by persons who do not normally enter transactions, including unusual dates/times of those transactions (e.g., close to month/quarter/year-end)

TYPES OF PAYROLL FRAUD

The fraudster is looking for several ways to steal. It's not that the fraudster has a brilliant scheme; our lack of internal controls allows fraud.

Although there is no limit to creativity, payroll fraud generally falls under one of these three categories:

1. Ghost or fictitious employees – a person on the payroll who does not work for the organization. This may include terminated employees, but the person usually never worked for the organization.

   - Terminated or deceased employee - This may include a real employee terminated and left on the payroll.
   - Fictitious employee - They may not have worked at the company at all and may not be an actual person!

Red flags include:

- Unusual or duplicate employee addresses
- Duplicate bank account numbers
- Duplicate SIN
- Birth dates that make the employee too old or young
- Manual adjustment entries in the pay register
- No deductions from the pay

Prevention/detection measures include:

- Pay advice should always be handed directly to the employee, not left on a supervisor's desk for pick-up.
- If electronic pay advice is used, hand deliver yearly bonuses or pay statements at least once yearly.
- Cross-reference the payroll roster for duplicate addresses or SIN.
- Investigate all returned T4 and RL-1 slips.

2. Time theft is a common payroll scam in altering time sheets to trigger overtime pay.

   - Unauthorized hours - Padding timesheets with unauthorized hours. Perhaps the most common type of payroll fraud occurs when the supervisors are known only to make cursory timesheet reviews.
   - Buddy Punching - Have a buddy punch you in on the time clock when you are late, leaving early or

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possibly on a day off!

- An employee working remotely - Reporting hours as being worked for time spent on non-work related tasks.

Red flags include:

- Unusually high overtime pay
- Employees paid for more than 24 hours
- Too many shifts/hours in the pay period
- Unsatisfactory productivity for a remote employee

Prevention/detection measures include:

- Supervisory reviews
- Policies on immediate termination of employment
- Organizations with biometric timekeeping systems can reduce this risk
- Manager or supervisor approval of all timecards or timesheets, including all overtime
- Executive approval of all bonus-type compensation
- Track actual hours worked with a time-tracking software on remote employee's work computer

3. False benefit expense claims – submission of false benefit claims generally falls under one of 3 categories:

- **Provider fraud -** A health care service provider exploits the plan by, for example, submitting false claims for procedures they never performed for a plan member. Usually, the plan member knows nothing about the fraud until the benefits advisor, the plan sponsor, or the underwriter discovers it.
- **Plan-member fraud -** Some plan members exploit their plans by fabricating claims and producing false receipts. They may also add fake dependents to their plan or make claims through their own and their spouse's plans without proper coordination of benefits.
- **Collusion between provider and plan member -** Sometimes, healthcare providers and plan members work together to exploit the plan, splitting their fraudulent gains. Usually, these collusions involve obtaining receipts for insurable expenses when there was no expense. For example, a plan member and an optical store employee might create a Vision Care billing for expensive prescription lenses when the member purchased a pair of uninsured designer sunglasses. In other cases, the collusion might be to inflate the cost or scope of a procedure or otherwise falsify treatment details to increase the reimbursements received from the health plan.

Prevention/detection measures include:

- Validate provider credentials.
- Ensure the provider uses random audits to detect suspicious or irregular claiming patterns.
- Analyze benefit costs.
- Assess claims against the coverage the plan was designed to provide.
- Verify the eligibility of plan members and their dependents.

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- Verify that services charged for are in line with best practices.
- Engage employees in an anti-fraud culture.
- Educate plan members on their role in controlling costs and the legal ramifications of fraudulent claims.
- Encourage members to review their receipts carefully and ask their providers questions.

Edward Nagel, an authority on forensic accounting, describes the 5 W's of Occupational Fraud: What, Why, Who, Where, and When.

1. What does occupational fraud look like?
2. Why and how does Occupational fraud occur?
3. Who is a Typical Fraudster?
4. Where are the red flags of fraud?
5. When should I be suspicious?

The best way to prevent payroll fraud is to reconcile all balance sheet accounts and payroll records monthly or, at the very least, quarterly. Look for any discrepancies and investigate them until there is a clear answer.

CYBERCRIMINALS TARGETING PAYROLL

The National Payroll Institute learned about a new scam targeting payroll professionals through social media in 2019.

This ongoing phishing scam involves emails targeting employee direct deposit account information. Cybercriminals use LinkedIn to identify individuals who work in payroll for an organization. Scammers then locate another employee of that organization and impersonate that employee by emailing the identified payroll representative from a private account requesting that their bank account information be updated to a fraudulent account.

The scam is often only identified when the payroll professional seeks clarification from the targeted employee and applies additional checks and balances before fulfilling the request.
Payroll professionals are warned to always apply heightened security for banking-related emails initiated by employees requesting to update or change direct deposit credentials. If you or your colleagues receive a suspicious email, forward it to your IT or HR representative. Protecting your employees' personal data is crucial.

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TEST YOUR KNOWLEDGE

1. An internal audit is conducted by:

    A. The Canada Revenue Agency
    B. Employees of or a consultant hired by an organization
    C. Revenu Quebec
    D. An employment or labour standards auditor

2. All of the following are benefits of conducting internal payroll audits, except:

    A. The organization will be exempted from external audits
    B. Payroll errors are identified and rectified
    C. The accurate remittance of statutory withholding is confirmed
    D. Ensuring inactive employees are not being paid

3. An internal audit is a comprehensive review of an organization's:

    A. Recruitment and hiring policies and processes
    B. Internal controls including corporate governance and accounting procedures
    C. Paid leaves such as vacation, sick leave, bereavement, personal development
    D. Reporting structure

4. Payroll fraud generally happens under all of the following categories except:

    A. Ghost or fictitious employees
    B. Time theft
    C. False expense or benefit claims
    D. Organization policies

TEST YOUR KNOWLEDGE - ANSWERS

1. An internal audit is conducted by:

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APPENDIX 1: PAYROLL ERROR LOG

A best practice is maintaining a payroll error log identifying issues reported each pay period. The level of detail would be anything your organization feels is important, but as a suggestion:

- The ID of the employee
- Pay date of the issue
- The employee's department
- The type of issue
    - o Company policy not followed
    - o Employment or labour standards
    - o Error

- The source of the error or how it was identified
- Details of the error
- The payroll team member assigned to investigate and correct
- How many days did it take to resolve
- Whether an off-cycle pay run was required

EE ID	Pay date	Department	Issue Type	Source	Details	Assigned to	Days to resolve	Off-cycle Req'd
23654	5/12/2023	Supply chain	Policy	Flagged	Excess OT	Admin 1	1	N
37982	5/12/2023	Administration	Compliance	Audit	Vacation Rate	Admin 2	8	N
56824	5/12/2023	Customer Service	Error	Time	Missing Hours	Admin 3	3	Y
69326	5/12/2023	Administration	Error	HR	New employee not paid	Admin 1	2	Y

Some payroll issues are recurring, and a log will assist in identifying these. In some cases, these types of issues can be reduced or eliminated by making necessary changes such as:

- Ensuring all managers and supervisors follow established organizational policies and procedures.
- Employees required to enter hours in a timekeeping system are doing so, accurately and on time.
- Managers or supervisors responsible for approving hours and releasing to payroll are completing on time. Consider if an adjustment to the cut-off schedule is feasible.
- HR knows the payroll schedule and communicates with new employees about when they will receive their first pay.
- Updating a process or implementing a new technology solution.

APPENDIX 2: INTERNAL AUDIT CHECKLIST

Audit Period	Start date:		End date:	

TASKS	COMPLETED	NOTES	ISSUES IDENTIFIED
Run Reports and Gather Information			
Payroll Register	☐		☐
Employee Data Report	☐		☐
Employee Hours Worked	☐		☐
Employee Pay Rates	☐		☐
Employee Overtime	☐		☐
Error Logs	☐		☐
General Ledger Detail	☐		☐
Verify Employee Data			
Employee or Self-employed review	☐		☐
Employee list correct-all active	☐		☐
Pay rates are accurate	☐		☐
Vacation accrual rates are accurate	☐		☐
Valid SIN for all employees	☐		☐
Accurate prrovince of employment	☐		☐
Time and Attendance			
Hours approved each period	☐		☐

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TASKS	COMPLETED	NOTES	ISSUES IDENTIFIED
Hours worked match pay	☐		☐
Adjustments to hour documented	☐		☐
OT hours calculated accurately	☐		☐
OT Paid at th correct premium rate	☐		☐
Paid leave approved	☐		☐
Accuracy of Employment Income			
Review employee expense claims for payroll items	☐		☐
All taxable benefits reported	☐		☐
Accurate taxable benefits values	☐		☐
Variable Income			
All payments authorized	☐		☐
Correct withholding applied	☐		☐
Statutory withholding			
Correct government pension (CPP or QPP) withheld	☐		☐
Accurate allocation of C/QPP pay period exemption	☐		☐
Correct EI premium rater applied	☐		☐
QPIP premiums for Quebec employees	☐		☐
Correct jurisdictional tax withheld	☐		☐
Accurate federal and provincial income tax calculations	☐		☐

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TASKS	COMPLETED	NOTES	ISSUES IDENTIFIED
Reconcile the Payroll Tax Account			
Remittances match the payroll register	☐		☐
Reminttances allocated to the correct account	☐		☐
Other payroll deductions			
Accurate RPP or RRSP contribution rate	☐		☐
Union dues are accurately calculated	☐		☐
Accuracy of garnishment deductions	☐		☐
Employee consent was obtained for all voluntary deductions	☐		☐
Payroll Accounting			
Correct allocation to GL accounts	☐		☐
Salary and wage expenses are applied to the correct cost centre Reconcile accounts payable - all payroll deductions remitted • CRA • RQ • Pension Administrator • Benefits provider • Garnishments • Other third-party	☐		☐

TASKS	COMPLETED	NOTES	ISSUES IDENTIFIED
Year- End			
Balance T4 reporting to the payroll register	☐		☐
Balance RL-1 reporting to the payroll register	☐		☐
Perform pensionable and insurable earnings audit	☐		☐
Validate the accuracy of workers' compensation assessable earnings	☐		☐
Validate the accuracy of provincial health tax assessable remuneration	☐		☐

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APPENDIX 3: RANDOM SPOT CHECKS

A periodic review of payments to individual employees is suggested to validate payroll entries. Conduct a random spot check of several employees from various departments for each of the following.

1. Manual review of gross to net pay; from hours worked to gross pay to deductions to net pay.
2. Ensure the required approval of variable payments such as bonuses, commission or retroactive pay adjustments was obtained. Validate the accuracy of the gross payment and that the correct statutory withholding was applied.
3. Validate that paid leaves have the required approval on file and that the correct payment has been processed.
4. Enrollment forms for payroll deductions. Validate that any company compulsory or voluntary deductions have the required documentation.
5. Review all earnings and taxable benefits values for an individual employee and validate the correct reporting on the T4 or RL-1 slip(s).

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FEEDBACK

The Institute appreciates your comments and welcomes your suggestions as we continually seek to improve our member resources. Please direct any feedback on these guidelines to:

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ACKNOWLEDGEMENTS

The Institute would like to thank the following subject matter experts for participating in the task force and contributing to these guidelines.

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