

Report from the City Auditor

**AUDIT OF SAP
PAYROLL CONTROLS**



OFFICE OF THE CITY AUDITOR

SEPTEMBER 2007

City of Palo Alto

Office of the City Auditor

September 18, 2007

The Honorable City Council
Attn: Finance Committee
Palo Alto, California

Audit of SAP Payroll Controls

SUMMARY

The Payroll Section in the Administrative Services Department processes timesheets, paychecks and pay statements for about 1,300 employees every other week. The Human Resources Department receives and processes Personnel Action Forms (PAF) and is responsible for updating employee pay rate information in the SAP computer system before the payroll is processed. The test results of the SAP Payroll module indicate that payroll data is generally reliable and authorization roles are functioning, except for three pay errors found during the audit. System access controls have improved, but since individuals with authority to approve timesheets can modify and approve any timesheet in their department, the City will have to continue to closely monitor transactions and rely on manual processes and paper documents to ensure transactions are valid and payments are correct. Staff has reviewed the information in this report and a staff response is attached.

DISCUSSION AND ANALYSIS

Background. SAP was implemented in 2003-2004 and is a relational database used to automate City processes and manage City resources. It is the City's primary financial management system. SAP is used to prepare payroll for employees and involves a complex process that integrates personnel data, approved timesheets, and pay data stored in the SAP database. Human Resources (HR) is responsible for inputting personnel and pay data. Employees (or their designees) enter timesheet data electronically; their supervisors approve timesheets electronically. The Payroll Section of the Administrative Services Department then prepares the bi-weekly payroll, withholdings, and annual pay statements. This process is shown in more detail on the attached flowchart.

This review is one in an ongoing series of reviews of the controls in the SAP system. This report contains the results of our recent review of SAP Payroll controls. As part of our review we reviewed SAP manuals, flowcharted SAP payroll process, identified internal controls used in the payroll process, interviewed employees who enter data into SAP, observed payroll operations, interviewed employees and managers responsible for payroll, compared HR data with SAP data, reviewed prior audit reports, and reviewed access controls to the SAP payroll module.

We traced SAP data from HR input to payroll output, tested the accuracy of calculations in the pay statements, and tested the accuracy of the SAP inputs and outputs for a sample of 34 employees. For the 34 payees in our sample, we reviewed the payee access authorizations to the SAP HR-Payroll modules; compared the employee Personnel Action Form (PAF) with the SAP data;

reviewed the timesheets for the pay period April 14 to 27, 2007; examined the general ledger generated by SAP; traced the pay data from the PAF to the employee timesheets to the general ledger to the SAP generated pay statements (including the gross and net earnings, withholdings, deferred compensation, and taxes) to the payments (including checks, electronic funds transfers, or direct deposits) issued by ASD and the Payroll Section.

The audit was conducted in accordance with generally accepted governmental auditing standards from April 2007 to June 2007.

Pay errors found. Among the 34 employees in our sample, we found three employees who incorrectly received a 3 percent pay raise effective January 6, 2007. As members of the Fire Chief's Association, the employees were not authorized to receive the pay increase because the memorandum of understanding had expired on June 30, 2006 and a new agreement for the bargaining unit had not been negotiated and approved. Payroll and HR have been alerted and are in the process of correcting the pay errors. The 3 pay errors occurred because HR had mistakenly included the employees in a spreadsheet of management employee pay increases that was uploaded to the SAP system.

Recommendation 1: HR should correct the identified errors in pay, and work with ASD staff to analyze how to improve the upload method and reports being used. At least once a year, HR should certify that each employee's pay data is accurate.

Data integrity is generally good and payroll controls are functioning. Except for the errors discussed above, our review within the Payroll Section and ASD indicated the payroll controls are adequate to ensure the payroll results are accurate, timely, and reliable. SAP application controls (such as edits, limits, and checks) are augmented by general controls within the Payroll Section.

The application controls address cost centers, employee number, job codes, employee classification, pay grade and steps, salaries, hourly rates, employee group, union membership, overtime rate, shift and night differentials, and other data elements.

The general controls currently include:

- payroll simulations before the payroll is actually run,
- manually addressing error reports,
- comparing simulation results with the general ledger,
- monitoring payroll results for unusual amounts or activity,
- reconciling the general ledger and bank accounts,
- reviewing financial reports and balance sheets (by comparing financial and actual data),
- compiling quarterly overtime usage reports for the City Council,
- retaining electronic copies of the pay statements and checks issued,
- retaining detailed listings of deferred compensation and other withholdings
- retaining detailed listings of payments sent to third parties,
- separation of duties, and
- running quarterly reports to monitor the earnings of individual ASD employees who have access to the Payroll module.

Except for the pay errors discussed above, we found no other errors in the pay statements that we sampled.

Additional improvements are needed in other areas. This includes improving the timeliness of personnel and pay documentation, monitoring the earnings of HR employees who have access to the HR-Administrator and HR-Payroll modules, removing former employees from the HR authorization tables (especially former employees who can approve and change timesheets in the HR_CATS_Administrator module), streamlining processing through requiring or increasing use of direct deposits, and improved contingency planning. Our specific recommendations follow.

HR Personnel Action Forms (PAFs) and inputs to the SAP system should be more timely. Data used to prepare payrolls should be accurate, timely and reliable. Pay rates in SAP are based on PAF data approved and entered into SAP by HR. At our request, HR provided the latest PAF forms for the employees in our sample. The PAF pay rates, salaries, or job titles did not match the data for 5 of the 34 payees in our sample. Staff in the ASD Payroll Section resolved the discrepancies for 2 employees by providing updated information that was not included in the PAF and proved the payments made to the employees were correct (PAFs had not been submitted for employees receiving extended working-out-of-class pay). The pay rates for the remaining 3 employees were incorrect, as discussed earlier.

Recommendation #2: Since HR is responsible for approving and providing current and accurate data to Payroll, HR should prepare corrected PAFs for the identified employees, and should work with departments to improve the accuracy of PAFs.

Management reports for monitoring HR employee earnings are needed. In ASD, 2 employees have access to the HR_Administrator module and 5 employees have access to the HR-Payroll module. These employees have the ability to create, modify, or input data affecting salaries, pay rates, pay steps, and other data affecting their own and other employees' pay. Because of this, their earnings are cross-checked as part of the Payroll quality assurance checklist. Quarterly management reports show each employee's earnings by pay period; the Accounting Manager reviews these reports for unusual earnings, monitors the earnings of each employee who has access to the HR-Payroll module, and certifies each report.

Similar reports are needed to monitor the earnings of HR employees who have access to the HR_Administrator module. Ten HR employees have access to the HR module as administrators and can create, modify, or input data affecting salaries, pay rates, pay steps, and other data affecting their own and other employees' pay. Routine monitoring of earnings of every employee who has access to the HR modules is an important internal control to ensure that unauthorized activity would be detected.

Recommendation #3: ASD should generate, and HR should certify, periodic earnings reports for HR employees who have access to the HR modules to monitor for unusual earnings and ensure all earnings are authorized.

Controls over access by ex-employees can be improved and the number of employees with timesheet approval authorities should be reduced. Over 225 City employees have authorization to approve and modify timesheets as HR_CATS_Administrators. These administrators can approve and modify any SAP timesheet in their department. We reviewed SAP authorities for the 34 employees in our sample, plus one consultant, and 10 retired and former employees. The consultant was no longer providing services to the ASD Payroll Section and was not able to access SAP because his password had expired. Among the 10 retired and former employees, 5 of them still had the authority to approve timesheets as HR_CATS_Administrators. In our opinion, these former employees should not be allowed to approve or modify timesheets and should be removed

from the SAP HR authorization tables. If the former employees gained access to the SAP HR module, they could create and approve timesheets that could result in payments that are improper. ASD's current policy is to deny access to the network and deactivate SAP accounts for terminated employees. We further recommend that:

Recommendation #4: Data base administrators for the SAP HR modules should remove the authorizations for former employees who no longer require access to the HR module, including former employees who can approve and change timesheets through the HR_CATS_Administrator module.

Recommendation #5: In the upcoming SAP upgrades, ASD should reduce the risk of improper or unauthorized approval of employee timesheets by restricting the authority to approve timesheets to only supervisors in the employee's chain of command, or by reducing the overall number of employees with broad authority to approve timesheets.

More direct deposits would streamline payroll operations. Studies have shown that electronic funds transfers (EFT) are less expensive and more efficient than issuing paper paychecks. In our sample of 34 employees, 6 persons (18%) were paid with a paper paycheck. ASD reports approximately 200 paper checks (about 15% of all employees) are issued each pay period. If these checks were lost or stolen, the Payroll section would have to place a stop payment order, reissue the check, and re-send the check to the employee; the employee would incur additional delays in receiving and accessing the funds through bank holds and other clearings. In contrast, EFT transfers and direct deposits of pay reduce the risk of lost, theft, and any delays in accessing the employee's pay. The EFT process also reduces the staff and processing costs related to paying the employee.

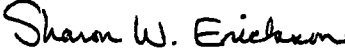
Recommendation #6: ASD should encourage all employees to receive their pay through the Electronic Funds Transfer method.

Payroll contingency plans and SAP system controls are still evolving. A payroll contingency plan for continued operations in the event of a disaster or emergency is still evolving. ASD staff is exploring alternatives for continued operations, including issuing handwritten or printed checks in the event of an emergency.

Recommendation #7: ASD should expedite development of its contingency plans for continued payroll operations and should formalize these plans as soon as possible.

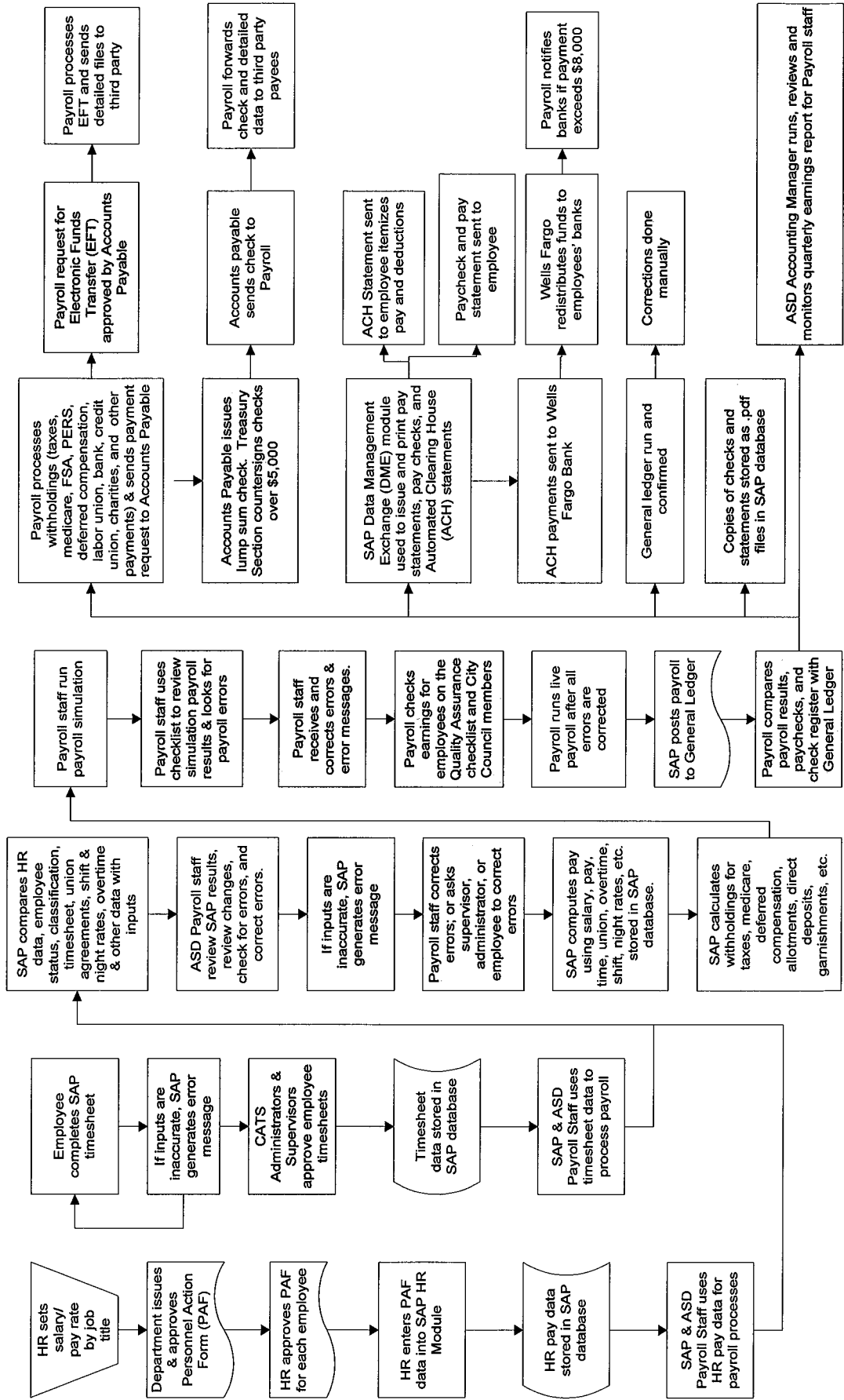
We thank the staff in the Administrative Services and Human Resources Departments for their cooperation and assistance during this review.

Respectfully submitted,


Sharon W. Erickson, City Auditor

Audit staff: Edwin Young

CITY OF PALO ALTO PAYROLL PROCESS





**Administrative Service Department
Human Resources Department**

MEMORANDUM

From: Frank Benest, City Manager

By: Carl Yeats, Director, Administrative Services Department
Russ Carlsen, Human Resources Department

Date: September 18, 2007

Subject: Response to Auditor's SAP Payroll Audit

The Administrative Services Department (ASD) is pleased to respond to the City Auditor's "Audit of SAP Payroll."

ASD strives to provide accurate and timely payment to City staff, while safeguarding the City's resources and financial systems. ASD is also proactive in implementing and facilitating the use of technical innovations to provide exceptional customer service.

RECOMMENDATION #1: HR should correct the identified errors in pay, and work with ASD staff to analyze how to improve the upload method and reports being used. At least once a year, HR should certify that each employee's pay data is accurate.

The error occurred because the data transferred from SAP to the spreadsheet of management employees being given a pay increase included Fire Chief Association (FCA) employees. HR will work with ASD to create a report which does not combine FCA employees with Management group employees. Currently, HR has the practice of checking each personnel file prior to entering a merit pay increase. However, this is not possible with group uploads to the SAP system. HR will work together with Payroll to audit uploads and improve accuracy.

Target completion date: FY 07-08, next group upload

RECOMMENDATION #2: Since HR is responsible for approving and providing current and accurate data to Payroll, HR should prepare corrected PAFs for the identified employees, and should work with departments to improve the accuracy of PAFs.

HR will be working with ASD to create an electronic PAF during the upcoming SAP upgrade project. The electronic PAF should have the capability to capture employee data from SAP and transfer it onto the PAF, thus, improving the accuracy of the PAFs.

Target completion date: With the SAP technical upgrade, scheduled for FY 07-08.

RECOMMENDATION #3: ASD should generate, and HR should certify, periodic earnings reports for HR employees who have access to the HR modules to monitor for unusual earnings and ensure all earnings are authorized.

Staff concurs ASD will generate a quarterly earnings report for HR staff. The quarterly earnings report will be sent to the HR director for review and certification. The certified earnings report would be kept on file with the HR director.

Target completion date: Calendar year 2007, third quarter. This would coincide with quarterly earnings reports already certified for payroll and IT staff.

RECOMMENDATION #4: Data base administrators for the SAP HR modules should remove the authorizations for former employees who no longer require access to the HR module, including former employees who can approve and change timesheets through the HR_CATS_Administrator module.

Staff agrees and will immediately implement the elimination of authorization to terminated employees in procedures. As part of the upcoming upgrade, the assignment of roles and authorizations will be modified to position based which will result in new procedures. ASD data base administrators will continue to deny access to the network and change the procedure to include removing authorization to SAP by deleting the employee account.

Target completion date: immediate implementation and with the SAP technical upgrade, scheduled for FY 07-08.

RECOMMENDATION #5: In the upcoming SAP upgrades, ASD should reduce the risk of improper or unauthorized approval of employee timesheets by restricting the authority to approve timesheets to only supervisors in the employee's chain of command, or by reducing the overall number of employees with broad authority to approve timesheets.

ASD concurs and is currently analyzing unused authorization approval for deletion. In addition, as part of the upgrade, ASD is developing a more comprehensive security validation as discussed in the prior response and will include ongoing analysis and review of roles; this would be for all SAP modules.

Target completion date: With the SAP technical upgrade, scheduled for FY 07-08.

RECOMMENDATION #6: ASD should encourage all employees to receive their pay through the Electronic Funds Transfer method.

Staff agrees it is beneficial to all parties to have direct deposit and ASD encourages use of direct deposit. Although the City cannot legally require direct deposit, it promotes its use by periodically sending out notification to all employees of the advantages of direct deposit including information on the availability of free banking with the City's bank and most banking institutions and credit unions. In addition, whenever ASD has to place a stop payment on a lost payroll check, we provide direct deposit application forms to the individual employee. We may also consider promoting direct deposit by highlighting its benefits to labor groups. Finally, the advantages of direct deposit are highlighted in the City's emergency plan as direct deposit will be the first priority of payroll processing in most emergencies.

Target date: Ongoing and pending approval of the payroll emergency plans.

RECOMMENDATION #7: ASD should expedite development of its contingency plans for continued payroll operations and should formalize these plans as soon as possible

We concur and ASD has developed an emergency plan, and has emergency check stock in multiple locations and offsite access to the financial system. A draft of the emergency plan is currently under review and once approved will become part of the City's emergency procedures.

Target Date: Resources are currently in place and procedures are currently under review.

Conclusion

The Administrative Services Department acknowledges the insightful work by the Auditor's Office and thanks them and agrees with the recommendations from the audit. Staff will work towards implementing the majority of recommendations and consider how to incorporate the recommendations in the system upgrade.