

**Performance Audit 15-03:  
Payroll Third Party Deductions**

**July 2015**

**City Auditor**

Stan Sewell, CPA, CGFM, CFE

**Internal Auditor**

Jennifer Benefield, CFE





# OFFICE OF INTERNAL AUDIT

## Stan Sewell, City Auditor

July 14, 2015

To: Mayor Andy Berke  
City Council Members

Subject: Payroll Third Party Deductions, Audit 15-03

Dear Mayor Berke and City Council Members:

The attached report contains the results of our audit of specific voluntary payroll deductions. Our audit found that overall internal controls are in place that substantially ensure deductions are properly authorized and submitted timely to third parties. However, we found the administrative contract with Total Administrative Services Corporation has minimal terms. We also found that some improvements are needed in internal controls for the third party deduction process. In order to address the noted areas, we recommended actions to expand the third party contract and enhance the review and reconciliation process.

We thank the management and staff of the Payroll Division, Human Resources Department and Purchasing Division for their cooperation and assistance during this audit.

Sincerely,

Stan Sewell, CPA, CGFM, CFE  
City Auditor

Attachment

cc: Audit Committee Members  
Travis McDonough, Chief of Staff  
Daisy Madison, Chief Financial Officer  
Brent Goldberg, Chief Operating Officer  
Todd Dockery, Human Resources Administrator

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## AUDIT PURPOSE

This audit was conducted in accordance with the Office of Internal Audit's 2015 Audit Agenda. The objectives of this audit were to determine if:

- Payroll deductions are properly authorized and calculations, if needed, are accurate; and,
- Proper internal controls are in place to ensure payroll deductions (except taxes and insurance) are submitted timely and accurately to the appropriate third party.

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## BACKGROUND

The City of Chattanooga offers its employees a wide range of benefits. In addition to health benefits, employees have the option to participate in voluntary deduction programs. Types of voluntary deductions include Flexible Spending Accounts (FSA), Health Savings Accounts (HSA), union dues, deferred compensation, charitable donations and memberships/clubs. The City also handles court mandated deductions such as tax levies, child support and bankruptcy. Medical, dental, vision and voluntary life and disability are offered, but are not in the scope of this audit.

The Payroll Division responsibilities include verifying deductions are properly authorized and updating the Oracle payroll system. The Benefits Division (Benefits) is responsible for the employee enrollment process, providing benefit information to third parties and reconciling the FSA and HSA contributions.

With the exception of HSAs, the voluntary deductions are entirely funded by the employee. HSAs are funded by employee deductions as well as City contributions based on medical coverage. Unlike the FSA funds, HSA funds can be rolled over year to year. Any FSA funds unused at the end of year are forfeited and held on behalf of the City in the Client Cash Account Balance.

For the FSA and HSA, the City has a service agreement with Total Administrative Services (TASC) to maintain employee FSA accounts, process FSA reimbursements and allocate HSA funds to HealthEquity. Per the contract, TASC receives \$4.50 per FSA participant and \$1.00 per HSA participant. The HSA funds are transferred to HealthEquity by TASC. HealthEquity maintains employee HSA accounts and processes reimbursements for medical expenses.

### Financial Information

In calendar year ending 2014, the payroll voluntary deductions were \$2.4 million. Over 1,600 employees participated in at least one of the voluntary deductions that are included in the scope of the audit.

#### Exhibit 1: Employee Voluntary Deductions

Voluntary Deductions	2012	2013	2014
Health Savings Contributions-Employee	157,183	158,604	174,958
Flexible Spending Account Contributions	331,833	352,991	353,592
Union Dues	219,528	229,964	270,182
Deferred Compensation (All companies)	914,223	1,347,407	1,307,498
United Way	73,328	68,846	64,478
Memberships/Clubs	263,426	257,640	259,038
Total Voluntary Deductions	1,959,521	2,415,452	2,429,746

Source: Oracle Financial Records

## FINDINGS AND RECOMMENDATIONS

### Detailed contract protects the City's assets.

A comprehensive contract provides protection to City employees and their funds. In addition, it outlines the responsibilities between the City and its vendor. Total Administrative Services Corporation (TASC) handles over \$700,000 annually of flexible spending and health saving account contributions. Currently, a service agreement is executed with minimal terms and conditions. For instance, the City has no recourse if the contractor does not timely allocate funds to the employee's account. We found, during the audit scope, 34% of the ACH transfers to HealthEquity occurred over 10 days after the payroll date.

To ensure protection of City and employee assets, we suggest the contract include terms such as, but not limited to: requirements for timely allocations to employee accounts, written authorization from the City to use funds from the Client Cash Account Balance, notifications to the City when changes to employee accounts are being made and confirmation of allocations completed. We also noted a copy of the agreement was not on file with the Council. *Internal Control and Compliance Manual for Tennessee Municipalities* requires a copy of all contracts entered into for services received or provided be filed with the minutes of actions taken by the governing body.

#### Recommendation 1:

We recommend the Benefits Division develop a contract detailing specific requirements and duties (conferring with the City Attorney, if necessary).

***Auditee Response:** We concur with the audit finding and recommendation.*

### **Recommendation 2:**

We recommend the contract, once developed, be provided to the Council.

***Auditee Response:** We concur with the audit finding and recommendation.*

### **Improvements in internal control are needed.**

While the overall process of signing up for third party deductions is effective, we found some areas in the process need improvement. These areas include appropriate signatures on authorization forms, supervisory review of manual calculations, and an automated reconciliation process. These recommendations should reduce the risk of errors.

### **Deduction forms should be properly authorized by signature.**

We reviewed a statistical sample of 50 employee files to verify if deductions had proper authorization. We found 2 employee signatures were not present on authorization forms. *Tennessee Wage Regulation Act Title 50-2-101* states an employer cannot make any deductions from an employee's paycheck without the employee's consent to the deduction.

### **Recommendation 3:**

We recommend the Payroll Division require all forms be properly authorized before the deduction is initiated. The form should be retained as supporting documentation.

***Auditee Response:** We concur with the audit finding and recommendation.*

### **Manual calculations should receive supervisory review.**

We found one instance in our statistical sample of a tax lien that was input incorrectly in the Oracle payroll system. This resulted in the City not deducting and paying the proper amounts required per the court order. The risk would decrease if, at a minimum, the supervisor verifies the accuracy of the entered amount.

**Recommendation 4:**

We recommend the Payroll Division have a supervisory review of third party deductions that require a manual calculation. The review should be documented and maintained.

***Auditee Response:** We concur with the audit finding and recommendation.*

**An automated reconciliation process for the FSA and HSA accounts would decrease errors and improve efficiency.**

We sampled 3 bi-weekly and 3 weekly pay periods out of 26 bi-weekly and 53 weekly pay periods. All deductions in the scope of the audit were reviewed to verify they were accurately submitted to third parties. We found some issues with the FSA and HSA amounts. To identify the cause of the discrepancies, we compared the Payroll Registers to the TASC allocation reports.

In most instances the Benefits Division corrected discrepancies within a reasonable amount of time. We noted some errors spanned months before being corrected. In one instance an error was not corrected until our audit identified the discrepancy.

Currently the FSA and HSA reconciliation is performed manually by the Benefits Division on a weekly basis. They compare the Payroll Register to the TASC PVR<sup>1</sup> by visually matching employee names and deduction amounts. The manual process is more prone to human error and is not as efficient as an electronic process.

Benefits has developed an excel template to electronically reconcile the actual payroll deductions to the TASC allocated amounts. However, this spreadsheet is not being utilized in the reconciliation process. This spreadsheet would assist the effectiveness of the reconciliation process, reduce the risk of error and improve efficiency.

**Recommendation 5:**

We recommend using the automated process previously developed by the Benefits Division to reconcile the FSA and HSA deductions on a weekly basis.

***Auditee Response:** We concur with the audit finding and recommendation.*

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<sup>1</sup> PVR- Payroll Verification Report that is provided by TASC. The report lists employees enrolled in the FSA and HSA benefit. TASC uses the report to allocate the payroll deductions.

**Criteria for FSA funds held by third party.**

Total Administrative Services Corporation administers the flexible spending and health saving account funds for City employees. After each pay period, the City sends an ACH to TASC for allocation to employee accounts. The funds are held in a Client Cash Account Balance until allocated to employee accounts. The Client Cash Account Balance held by TASC was in excess of \$35,000 as of April 2015. This balance fluctuates due to early disbursements and forfeited funds.

The Internal Revenue Code Section 125 requires that the maximum amount of reimbursement from a health care FSA be available at all times during the coverage period. It prohibits employers from charging an employee the balance of their FSA if he/she terminates mid-year. In this case, funds from the Client Cash Account balance are used to cover the reimbursement. At the end of every calendar year, any flexible spending account funds not used are forfeited to the City. These funds are returned to the Client Cash Account Balance.

Per the Internal Revenue Code, employers can only use forfeited employee contributions for administration costs or they may be allocated to employees who contribute on a uniform basis. However, we noted in April 2013, TASC used funds from the Client Cash Account Balance to fund employee accounts.

**Recommendation 5:**

We recommend the Benefits Division determine the proper minimum balance needed in the Client Cash Account Balance. We recommend any amounts in excess be used in accordance with IRC Section 125 rules.

*Auditee Response: We concur with the audit finding and recommendation.*

**Recommendation 6:**

We recommend the Benefits Division review the Client Cash Account balance annually.

*Auditee Response: We concur with the audit finding and recommendation.*

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## APPENDIX A: SCOPE, METHODOLOGY AND STANDARDS

Based on the work performed during the preliminary survey and the assessment of risk, the audit covers the third party deductions from January 1, 2014 to December 31, 2014. When appropriate, the scope was expanded to meet the audit objectives. Source documentation was obtained from the Payroll Department, Human Resources and Total Administrative Services Corporation. Original records as well as copies were used as evidence and verified through physical examination.

We interviewed Payroll Department and Human Resources staff. In addition, we reviewed *Internal Control and Compliance Manual for Tennessee Municipalities*, Internal Revenue Code, Chattanooga City Code and Tennessee Code Annotated for pertinent facts related to our audit.

The sample size and selection were statistically generated using a desired confidence level of 90 percent, expected error rate of 5 percent, and a desired precision of 5 percent. Statistical sampling was used in order to infer the conclusions of test work performed on a sample to the population from which it was drawn and to obtain estimates of sampling error involved. When appropriate, judgmental sampling was used to improve the overall efficiency of the audit.

We conducted this performance audit from January 2015 to June 11, 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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