FINANCIAL MANAGEMENT
FOR GEORGIA LOCAL UNITS
OF ADMINISTRATION

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INTRODUCTION

Payroll administration is a very important function of the business office of a Local Unit of Administration (LUA). In the accounting function, if an accountant makes an error, a simple general journal entry can be made to correct the error. However with the payroll function, mistakes can cause benefit issues for employees, tax payment errors, and even loss to the LUA if not corrected immediately. In addition, if the payroll is incorrect, a manual check may be necessary to correct the error. Then, the manually prepared check information must be entered into the computer, resulting in more risk of error. Therefore, absolute accuracy in payroll administration is vitally important.

In LUAs, payroll and the related benefit costs comprise a major portion (i.e., usually up to 80% - 85%) of the LUA budget. Since payroll personnel are responsible for the accurate and timely disbursement of approximately 80-85% of the LUA's appropriations, it is easy to see the importance of the payroll administration function.

Payroll administration is closely related to both human resource and financial management. Human resource management is involved because personnel actions are necessary to place an employee on the payroll or to modify an employee's status. Personnel policies on such matters as leave, pay adjustments, and benefits are the basis for payroll actions. Adherence to these policies requires that those responsible for timekeeping and payroll be familiar with the policies and be notified of all changes in an employee's status. A payroll operation also can provide valuable personnel information as a by-product. For example, statistical data on the age composition of employees is useful in determining when retirements are likely to occur. Also, information on overtime and turnover is also available from the payroll operation. These and other kinds of personnel data can be useful to LUA management. Therefore, it is important that the personnel aspects of payroll administration be fully understood. Payroll preparation and disbursement as well as accounting for payroll expenditures are all financial activities. LUAs must develop adequate controls to prevent errors and abuse. This control extends through all phases of the payroll administration from timekeeping to proper expenditure account posting. The finance department is concerned with the accuracy of payroll calculations, adherence to the budget, and the maintenance of proper accounting records.

Chapter I-11 provides specifics regarding the accounting for payroll and payroll deductions.

PAYROLL POLICIES

A number of basic policy decisions must be made relative to a payroll system. These include decisions on:

- the length of the pay period,
- the lag period from the date the work period ends to the day the payroll disbursement is made, and
- the number and type of discretionary payroll deductions allowed.

Payroll Periods

In most LUAs, certified staff and central office staff are paid monthly, usually on the last work day of the each month. Custodial and food service personnel often are paid monthly as well, although some LUAs may pay biweekly. The frequency of payrolls is a local decision and will vary among LUAs. Payroll periods typically can be monthly, semimonthly, biweekly, weekly or some combination of these options.

Biweekly pay periods offer certain advantages, especially the scheduling of pay on the same day of the week. The staggering of payroll periods for different groups of employees and the uniform number of days in each pay period simplify the computation of overtime and deductions for time off. A major problem of biweekly pay periods is the possibility of having a 27th pay day approximately every eight years. If a biweekly payroll cycle is chosen, care should be taken to ensure personnel costs are properly budgeted for the fiscal year.

Payroll Lag Time

Another policy matter involves the lapsing of time between the end of a pay period and the issuance of pay checks for that pay period. This lag time allows time sheets to reach the payroll office for verification and subsequent preparation and payroll disbursement. If lag time is not allowed, there is risk an employee may receive pay for time not worked. This can be a serious problem in the case of temporary employees. Lag times can run from one day to over fifteen days with five days being the most common. If not currently in effect, the provision of such lapse time should be implemented gradually so as not to inflict undue hardship on the employees. In no circumstances, should an employee be paid for a period not yet worked.

Payroll Deductions

LUAs continually are faced with an increased demand for additional types of payroll deductions. Traditionally, these deductions have included Federal and State withholding taxes, social security and Medicare taxes (FICA, Federal Insurance Contribution Act), retirement contributions, and life and health insurance premiums. In addition, employees request deductions for tax sheltered annuities saving bonds, credit unions, loan repayment, uniform payments, employee organization dues, and charitable causes.

Providing for deductions can be a costly and time consuming task. Various reports may be needed and separate accounting reconciliations may be necessary. Other problems include designing earning statements to reflect all deductions. In many computer operations, the capacity for a large number of deductions can be limited. Moreover, considerable employee time must be devoted to answering inquiries about deductions.

A policy decision should be made by the school board regarding the number of voluntary deductions to allow. These additional deductions place a considerable additional burden upon the payroll preparation staff and should be evaluated carefully as to their cost effectiveness prior to their being approved as deductions for employees of the LUA.

Many times, such additional deductions are authorized by the school board without any thought being given to the additional work load and time demands being placed upon the person(s) who prepare the payroll. Any additional workload must be evaluated carefully.

Centralized Versus Decentralized Payroll System

A payroll system consists of authorizing payroll additions and changes, timekeeping, payroll preparation, paying employees and distributing charges for personal services to the proper accounts. The centralization of these activities provides for uniform treatment of all employees and more effective control. Timekeeping is usually a departmental function (decentralized) while payroll preparation and record keeping is handled centrally. In most instances, central control should be exercised over timekeeping in order to guarantee adherence to rules and regulations (specifically the Fair Labor Standards Act, FLSA) and to prevent lax practices. The FLSA relates primarily to paying overtime pay to various classes of employees who work a specified number of hours in a particular payroll period.

As a minimum, the final audit and approval of payrolls and the issuance of checks should be handled centrally. The centralization of the payroll function permits the establishment of a uniform system of timekeeping, record keeping and payroll processing. Payroll terms can be defined, rules developed and written procedures issued. Written regulations regarding tardiness, lunch and rest periods, leaving the work place, overtime and calculation of pay for partial pay period are vital. Moreover, well-defined procedures and forms are needed for authorizing additions to the payroll and for change notification.

PAYROLL RECORDS

The basis of a sound payroll system is the records which are used. As a minimum, these include

- forms used to appoint and terminate personnel and authorize other personnel actions such as leave,
- daily attendance reports,

- time sheets,
- payroll and deduction registers,
- checks, check registers,
- statements of earnings and deductions, earning records,
- annual Federal and State W-2 reports,
- annual Federal 1094 and 1095 reports for ACA,
- quarterly Federal 941 reports and State G-7 reports,
- other reports associated with savings bonds, pensions, hospitalization, credit unions, dues deductions, tax shelters, etc.

This enumeration of forms and reports indicates the large volume of paper work and record keeping involved in payroll administration. These records, however, are essential to achieving uniformity. They should be designed, issued, and controlled centrally. Detailed instructions on the use of forms should be provided. Written payroll and timekeeping procedures outlining the steps to be followed can do much to prevent errors and simplify payroll activities.

Electronic forms are utilized for the abundance of recordkeeping associated with the payroll process. Employees generally can access these forms and complete them online. The form can be signed and forwarded to the payroll department. The use of electronic forms allows employees access to the most current version and eliminates the cost of reproduction. When designing forms it can be useful to contact other LUAs to obtain samples. Many forms manufacturers have developed standard payroll forms which can be adapted to local use. In addition, some software programs provide employee self service portals that allow online form completion and submission.

The Internal Revenue Service (IRS) requires employers to keep track of and add to an employee's gross taxable income personal use of employer-provided vehicles. IRS Publication 15-B provides guidance for taxation of fringe benefits.

PAYROLL AUTHORIZATIONS

The first step in a payroll system is the authorization for an employee to be placed on the payroll. Provision should be made for written authorization by the appointing authority. The procedure should also provide the finance office with approval regarding availability of funds and conformance to the budget. Copies of the authorization form serve as notices to the timekeeper and payroll office to add, remove or modify the status of an employee.

Forms authorizing a payroll action should be examined to determine that the titles and salaries or wages are proper and in conformance with the salary schedule and classification plan. A determination should also be made that there is adherence to all rules and regulations. A single form is usually adequate for notification of appointments, terminations, and changes including classifications, name, address, work location, leaves, promotions, and transfers.

TIMEKEEPING

As indicated earlier, timekeeping is primarily a departmental function. Provisions, however, should be made for central control and review. Accurate timekeeping assures that only legitimate names are carried on the payroll and that employees are only paid for time earned. Timekeeping is also essential for accurate cost accounting. The methods for keeping time include the use of a time clock or provision for the employees to record their arrivals and departures. Time clocks, both manual and computerized, are the most accurate form of keeping time. Provisions should be made to prohibit employees from recording the time of their fellow workers. Electronic time clocks are most commonly used for hourly employees and are usually not practical for employees who may not have access to the online timekeeping system. Use of attendance sheets usually work best in these situations, as well as with salaried employees. Employees record their arrival and departure times on attendance sheets along with their signature. The time of hourly field personnel is usually recorded by foremen or field timekeepers. Salaried field personnel are often required to complete a form which documents the location of stops they make during the day and time spent at each location.

Daily attendance reports should be pre-printed in a central location to show name, employee number, and title. The information from time cards or daily attendance reports is posted on time sheets by the timekeeper. Written instructions should be provided on how to complete daily attendance reports and time sheets. There is also a need for a flow of documents to keep the timekeeper and payroll office informed of changes. Time sheets should be pre-printed by the central payroll office to show the pay period, the operational unit, employee name and number, title, eligibility for overtime hours, and other pertinent information.

Time Sheet

A time sheet supplies the evidence that wages and salaries are due and payable. The sheet lists each employee and shows the time he worked. Salary checks are prepared from this time sheet.

A subsidiary record to the payroll is the "Employee Earnings Record." This record is created for each employee. It includes the total earnings of an employee, the deductions from these earnings, and the net pay the employee received. A form for an "Employee Earnings Record" is illustrated in Chapter I-11. When the salary check is issued or direct deposit is transmitted, the number of the check or remittance advice is posted to the appropriate column of the earnings record. The total amount paid for salaries and wages is calculated and the deductions are posted to the various columns across the earnings record.

All timekeepers should be aware of the availability of previously earned leave which may mean the difference between paid and unpaid absences. Through the use of computers it is possible to have this information accumulated centrally.
Payroll records are an essential part of the whole payroll function. Because of this it is vital that the forms used are updated when needed. Revision of forms and the design of forms are essential ingredients to a good payroll system.

The four basic payroll records include the payroll journal or register, individual earnings records, annual statement of earnings (W-2) and, of course, the payroll check or direct deposit advice. Each of these contains essentially the same information and, therefore, much of the work involved is of a repetitive nature.

INTERNAL CONTROL OF THE PAYROLL PROCESS

One of the basic concepts of internal control is the separation of the various components of a financial function among two or more persons. This separation would make an attempted defalcation more difficult because it would require the collusion of two or more persons. Some suggested procedures for effecting internal controls as they relate to payroll administration are as follows:

- *Centrally prepared payroll from verified time sheets*. The payroll checks should be prepared at a central point by persons other than those who keep the time sheets. The time sheets should be verified by someone other than the person preparing them. Payroll checks should be prepared only from verified time sheets.

- *Distribution of Checks or Transmission of Direct Deposit*. The payroll checks should be distributed by someone other than the person who prepares the time report. In addition, the direct deposit transmission should be performed by someone other than the payroll processor. Periodically, the auditors should, on an unannounced basis, collect all payroll checks at the central preparation point and distribute them to the employees at their work stations. They should have each employee receiving a paycheck furnish identification and sign for his check. This will insure that only those entitled to receive a check for that pay period will actually receive one. Auditors often peform other types of testing, such as data mining to verify the receipt of payment for services whether through an actual paper check or through a direct deposit.

- *Reconciliation of payroll checking account.* The payroll checking account should be separate from all other accounts and should be reconciled monthly with all exceptions accounted for. Further, the individual who reconciles the payroll checking account should not be the individual who writes or gives out the payroll checks.

The deposits to the payroll checking account can either be the gross total or the net total. If the gross is deposited then the various deductions taken from the employees are held in the payroll account and separate payroll checks are written to pay out for the various deductions, i.e., withholding tax, social security, group insurance, etc. If only the net pay is deposited then the checking account would have a zero balance when all the paychecks are cashed and the various deductions withheld would be retained in the other operating funds until disbursed. Both systems work and, generally, it is up to each finance department as to which system it likes.

CAFETERIA PLANS

A cafeteria plan is a tax-favored method of offering a variety of fringe benefits to employees under a single-plan maintained by the LUA. The qualification, taxation, and reporting requirements are governed by the Internal Revenue Code (IRC) article 125.

As its name implies, a cafeteria plan may provide LUA employees with a "menu" of benefits options. However, a cafeteria plan can be as simple or as complex as the LUA chooses. For instance, one form of cafeteria plan, the flexible spending plan (flex plan) may differ between LUAs. Some flex plans include only health and welfare benefits such as medical insurance. Other plans may give employees the option of purchasing a wide range of taxable and nontaxable benefits. Also, an LUA may set a minimum standard for some insurance benefits and keep those benefits outside the plan, but allow additional insurance coverage or other benefits to be purchased under the flex plan. In summary, the LUA has a great deal of flexibility in the design of the cafeteria plan.

Purchasing Benefits

Under IRC article 125, employees are allowed to pay for qualified flex plan benefits with pretax dollars. Since the pretax contribution reduces taxable wages, this method of payment is referred to as "salary reduction."

In addition, employees may pay for flex plan benefits with after-tax dollars (regular payroll deduction). In fact, an after-tax deduction may be a more favorable alternative to the pre-tax contribution for such benefits as group-term life and disability insurance.

Cafeteria Plan Advantage

The primary reason for adopting a cafeteria plan is the tax savings that can be realized. Without a cafeteria plan, benefits such as medical and dental insurance are paid on an after-tax basis. In other words, the payroll deduction does not lower the employee's taxable earnings. But under a cafeteria plan, certain benefit contributions may be paid on a pretax basis. Thus, the employee and employer may realize significant tax savings under a cafeteria plan.

Cafeteria Plan Disadvantages

In spite of its obvious merits, there are a number of reasons why many LUAs are reluctant to implement a cafeteria plan, including the following:

Administrative burden. Cafeteria plans require more administrative support than the traditional benefit plan. Enrollment, record keeping, discrimination testing, and monitoring for statutory compliance are tasks that require additional staff resources. For many LUAs, the services of a qualified benefits consultant are necessary, thereby increasing the cost of providing the plan.

Employee communications. Where a cafeteria plan's options are varied and complex, many employees may require assistance in making wise plan elections. Some LUAs spend a great deal of time and money providing orientation materials to assist employees during the enrollment process.

Nondiscrimination Rules. A cafeteria plan can lose its qualified status if it disproportionately favors or "discriminates" in favor of highly compensated employees or key employees by allowing them to receive greater tax advantages or benefits than other participants. To meet nondiscrimination requirements, a cafeteria plan must pass two tests: the contributions/benefits test and the eligibility test.

> *The contribution/benefits test.* Total benefits and nontaxable benefits (or employer contributions allocable to each) attributable to the highly compensated employees may not be significantly greater than the total benefits and nontaxable benefits attributable to other plan participants. Total benefits and nontaxable benefits are measured as a percentage of total compensation; they must bear a uniform relationship to participants' compensation.
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> *The eligibility test.* The three-part test to establish employees' eligibility to participate includes the following requirements:
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> - The plan must benefit employees qualifying under a classification that the IRS determines does not discriminate in favor of highly compensated employees.
> - The waiting period for enrollment in the plan does not exceed three years, and the employment requirement for each employee is the same.
> - Any employee who meets the length-of-service eligibility requirements is permitted to participate in the plan no later than the first day of the first plan year beginning after the date the employment requirement was satisfied.

Benefits Allowed

For a cafeteria plan to be qualified, it must offer participants the choice between at least one qualified (nontaxable) benefit and one cash (taxable). Thus, the cafeteria plan that offers participants the choice of only nontaxable benefits is not a qualified plan.

Nontaxable benefits permitted. The following nontaxable benefits may be included in a cafeteria plan:

- Accident and health insurance under IRC article 105 including vision and dental care, HMOs, PPOs, and managed care plans.
- A self-insured medical reimbursement plan if the plan benefits are deemed to be nontaxable outside of the cafeteria plan.

- Group-term life insurance (i.e., the first $50,000 of coverage) under IRC article 79.

- Dependent care assistance (i.e., the first $5,000) under IRC article 129.

Taxable (or cash) benefits permitted. Employees are allowed to pay for certain taxable benefits with pretax contributions; however, income must be recognized when the benefit is actually received. Taxable benefits allowed in a cafeteria plan are discussed below.

- Group-term life insurance over $50,000. Employees may purchase taxable group-term life insurance with pre-tax contributions under a flexible benefits plan; however, the pre-tax contribution is deemed to be an employer contribution for tax purposes and does not reduce taxable income computed under IRS rules.

- Group disability insurance. Employees may pay for group disability insurance with pre-tax contributions under a cafeteria plan; however, pre-tax contributions are deemed to be LUA contributions for tax purposes. Thus, should the participants receive disability benefits under the policy, 100% of the payments would be considered taxable income. For this reason, it may not be wise for employees to purchase group disability insurance with pre-tax dollars.

Flexible Spending Accounts (FSAs)

Flexible spending accounts or "reimbursement accounts" are an optional feature of the cafeteria plan. There are two reimbursement accounts allowed: (1) a health care reimbursement account, and (2) a dependent care reimbursement account.

Health care reimbursement account. Employees elect to contribute pretax dollars for qualified medical expenses at the beginning of the plan year. These pre-tax contributions are deducted from wages, thereby lowering the employee's federal and state income taxes and FICA taxable wages. As employees incur qualified expenses, they are reimbursed up to the total amount that they elect to contribute at the beginning of the plan year. The advantage of an FSA is obvious. The participant's out-of-pocket medical and dependent care expenses are reduced by the tax savings associated with the pre-tax contribution.

Dependent care assistance spending accounts. Under a dependent care assistance spending account, an employee may be reimbursed up to a maximum of $5,000 ($2,500 for married taxpayers filing separately) per year for qualified dependent care expenses. The spending account may be funded with flex credits or by salary reduction (pretax contributions). Unlike health care FSAs, the employee may only be reimbursed with contributions he or she actually made to the spending account.

Qualified dependent care assistance reimbursements. Many people believe that dependent care assistance reimbursements are made exclusively for child care expenses. This is not the case. Reimbursements may be made for non-medical expenses that enable an individual to work while ensuring a *dependent's* well-being and protection. A qualified dependent is: (1) a child under the age of 13, (2) a disabled spouse, and (3) other dependents who are physically or mentally challenged and in need of regular care.

Federal Tax Treatment

Some of the benefits purchased through a cafeteria plan are taxable and some are not taxable.

Salary reduction (pretax contributions). Employee pretax contributions to a qualified cafeteria plan (including health care and dependent care FSAs) are exempt from federal taxes, even if pretax contributions are used to purchase taxable benefits. However, the taxable benefits are taxable when actually received by the recipient to the same extent that they are taxable outside of the cafeteria plan.

After-tax contributions. Benefits that are purchased with after-tax dollars are exempt from federal taxes. However, because the contribution is made on an after-tax basis, the contribution does not reduce the amount of wage subject to federal taxes.

LUA contributions. LUA contributions toward benefits included in a qualified cafeteria plan are exempt from federal taxes to the extent the benefits are exempt from tax outside of the cafeteria plan. Conversely, employer contributions toward benefits included in a qualified cafeteria plan are taxable and subject to federal taxes to the extent the benefits are taxable outside of the cafeteria plan.

Reporting Requirements

Form 941 reporting requirements. Pretax contributions under a qualified cafeteria plan are not included on Lines 2 (total wages), 5a (social security wages), or 5c (Medicare wages) of form 941. Taxable benefits received under the plan are subject to the reporting requirements that would have applied had they been offered outside of the cafeteria plan.

Form W-2 Reporting Requirements

Salary reduction. In general, pretax contributions to a qualified cafeteria plan, including pretax contributions to a health care FSA, are not reported in Box 1 (wages), Box 3 (social security wages), or Box 5 (Medicare wages) of the W-2 form. At the employer's option, pretax contributions or tax-free employer contributions to a cafeteria plan may be reported in Box 14 "Other" and must be labeled according to type. Taxable benefits received under a cafeteria plan are reported as though they were offered outside of the plan.

Dependent care assistance. Pretax contributions applied to a dependent care assistance flexible spending account must be reported in Box 10 on the W-2 form. Any excess over $5,000 must be reported in Boxes 1, 3, and 5 as well.

Form 940 reporting requirements.

Salary reduction. In general, pretax contributions to a qualified cafeteria plan, including pretax contributions to a health care or dependent care FSA are included on the Form 940, Part 2, Line 3, "total payments." Since salary reductions under a cafeteria plan are exempt from FUTA, the total amount of the salary reduction is included in Part 2, Line 4, "exempt payments." Check the appropriate box listed below Line 4.

Dependent care assistance FSAs. Pretax contributions or employer contributions up to $5,000 per year are exempt from FUTA and are reported in Part 2, Line 4 as an exempt payment. Contributions in excess of $5,000 are FUTA taxable and should not be reported as a FUTA exempt payment.

General recordkeeping requirements. Any LUA maintaining a cafeteria plan during any year must keep such records as may be necessary for purposes of determining whether the requirements for the exclusions from income are met.

Form 1094 and 1095 reporting requirements

There are reporting requirements related to the Affordable Care Act under Internal Revenue Code Sections 6055 and 6056 that went into effect for calendar year 2015. Employers with 50 or more full-time employees (including full-time equivalent employees) will use Forms 1094-C and 1095-C (located at www.IRS.gov) to report the information required regarding offers of health coverage and enrollment in health coverage for their employees.

One aspect to consider regarding the reporting requirements for Form 1094-C is how your district will document the hours worked of employees that currently are not offered health insurance. For example, if substitutes are paid based on days worked instead of hours worked, your district will need to consider how those days worked will be converted to hours worked to determine eligibility for health insurance coverage.

Due to the reporting requirements, we recommend using an hourly rate when feasible to capture the activity of various employees. However, if an hourly rate is not practical, please understand that **a conversion process to report eligibility to the IRS will be necessary**.

Form 1095-C, Part III, requests information for each employee and covered individuals. The information from the State Health Benefit Plan is provided by ADP on an annual basis.

SUMMARY

1. Since payroll personnel are responsible for the accurate and timely disbursement of approximately 80-85% of the LUA's appropriations, it is easy to see the importance of the payroll administration function.

2. Payroll periods vary depending on employee function and present different challenges in processing payment.

3. Lag time between time worked and payment to employees is common and should be minimized when possible.

4. Payroll deductions can be administratively time consuming, and therefore, should be seriously considered by the LUAs board before adding.

5. The centralization of payroll activities provides for uniform treatment of all employees and more effective control.

6. Payroll records are an essential element to the payroll process and therefore, should be carefully designed and controlled.

7. Procedures should be established to determine proper authorization before employees are added, removed, or changes are recorded to payroll records.

8. Timekeeping is a crucial element to the payroll process and must be properly controlled.

9. Establishing appropriate internal controls is an essential part of the payroll process.

10. Cafeteria plans offer tax saving options to both employees and employers. Due to their complexity, only those properly knowledgeable of IRS requirements should administer the plan. In addition, special reporting relating to cafeteria plans is required for forms 941, 940, and W-2.