

Board of Governors of the Federal Reserve System

The Board's Payroll Controls Are Generally Effective



Office of Inspector General
Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection



Office of Inspector General

Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

Executive Summary, 2021-FMIC-B-008, June 7, 2021

The Board's Payroll Controls Are Generally Effective

Finding

The Board of Governors of the Federal Reserve System's payroll controls are generally effective in ensuring compliance with applicable laws, regulations, policies, and procedures. We used data analytics to identify potentially unusual transactions and to test categories such as premium pay, salary adjustments, tax withholdings, and payroll deductions and additions.

Our follow-up activities identified one instance in which the Board did not comply with its compensation policy. In that instance, an employee's base salary exceeded the grade-level salary maximum for 5 months. Implementing an additional payroll control to detect instances of employee pay exceeding grade-level maximums can help the Board to ensure that it compensates its employees in accordance with its internal policies.

Recommendations

Our report does not contain any recommendations. After becoming aware of our finding, Payroll implemented a control to validate the pay information it uses to process the biweekly payroll. We observed the execution of the control and found it to be effective. In response to our draft report, the chief financial officer states that the Division of Financial Management is pleased with our audit finding and that it remains committed to continuing an effective control environment.

Purpose

We conducted this audit to assess the effectiveness of certain payroll internal controls designed to ensure compliance with applicable laws, regulations, policies, and procedures. The scope of our audit covered January 1, 2019, through March 31, 2020; during this time period, Payroll processed \$498.5 million in payments to 3,112 Board employees.

Background

The Federal Reserve Act grants the Board broad authority over employment matters, including employee compensation. Under this authority, the Board has designed and implemented its own compensation and benefits programs. Although the Board is not subject to many federal personnel statutes and regulations, it voluntarily complies with federal standards for overtime pay. Additionally, the Board generally follows requirements to withhold applicable federal and state taxes. The Board's Payroll function is responsible for processing the Board's biweekly payroll in accordance with applicable laws, regulations, policies, and procedures.



Office of Inspector General
Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

Recommendations, 2021-FMIC-B-008, June 7, 2021

The Board's Payroll Controls Are Generally Effective

Number	Recommendation	Responsible office
	No recommendations.	



Office of Inspector General

Board of Governors of the Federal Reserve System
Bureau of Consumer Financial Protection

MEMORANDUM

DATE: June 7, 2021

TO: Ricardo A. Aguilera
Chief Financial Officer
Board of Governors of the Federal Reserve System

FROM: Cynthia Gray *Cynthia Gray*
Assistant Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2021-FMIC-B-008: *The Board's Payroll Controls Are Generally Effective*

We have completed our report on the subject audit. We conducted this audit to assess the effectiveness of certain Board of Governors of the Federal Reserve System payroll internal controls designed to ensure compliance with applicable laws, regulations, policies, and procedures.

We provided you with a draft report for review and comment. In your response, you concur with our finding and state that you remain committed to continuing an effective control environment. We have included your response as appendix B to our report.

We appreciate the cooperation that we received from your staff during our audit. Please contact me if you would like to discuss this report or any related issues.

cc: Patrick J. McClanahan
Steve Bernard
Thomas Murphy
Craig Delaney
Lisa Hegarty
Winona H. Varnon
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Introduction

Objective

Payroll is the largest component of the Board of Governors of the Federal Reserve System’s operating costs. Personnel expenses account for approximately 70 percent of the Board’s annual operating budget. We initiated this audit because our office has not reviewed the Board’s payroll processes since 2007.

The objective of our audit was to assess the effectiveness of certain payroll internal controls designed to ensure compliance with applicable laws, regulations, policies, and procedures. We used data analytics to detect potentially unusual transactions and to run general tests on categories such as premium pay, salary adjustments, tax withholdings, and payroll deductions and additions. We considered the scope of the Board’s 2019 financial statement audit, conducted by an independent public accountant, in designing our testing. Our audit scope covered payroll transactions that occurred from January 1, 2019, through March 31, 2020.¹ These transactions totaled \$498.5 million in payments to 3,112 Board employees. Details on our scope and methodology, including detailed descriptions of our testing approaches, are in appendix A.

Background

The Federal Reserve Act grants the Board broad authority over matters of finance, employment, and employee compensation.² Specifically, the Federal Reserve Act states that Board employment and compensation will be governed “solely” by the provisions of the Federal Reserve Act and the rules and regulations of the Board consistent with the act. As such, many federal personnel statutes and regulations do not apply to the Board.³ However, the Board voluntarily complies with the Fair Labor Standards Act of 1938, as amended, which provides for several employment standards, including overtime pay.⁴ Additionally, the Board generally follows the requirements to withhold federal and state taxes from the salaries of its employees, based on employees’ elections.⁵

The Board’s Compensation and Benefits Programs

Given that the Board is not subject to many federal personnel statutes and regulations, the Board designed and implemented its own compensation and benefits programs. The Board’s compensation

¹ To maintain our independence, we excluded payroll transactions for OIG employees from this audit.

² 12 U.S.C. § 244.

³ A Payroll official indicated that the Board generally follows the following statutes: 5 U.S.C. § 5520a (Garnishment of pay); 15 U.S.C. chapter 41, subchapter II (Restrictions on garnishment); 42 U.S.C. § 659 (Consent by the United States to income withholding, garnishment, and similar proceedings for enforcement of child support and alimony obligations); 26 U.S.C. § 3402 (Income tax collected at source); and 26 U.S.C. § 4980H (Shared responsibility for employers regarding health coverage).

⁴ 29 U.S.C. chapter 8.

⁵ The general requirement for employers to withhold federal income tax is codified at 26 U.S.C. § 3402; 5 U.S.C. § 5517 generally requires employers to comply with applicable state income tax withholding requirements. Employees make elections that determine the amounts, if any, the Board withholds for federal and state income taxes from their pay.

programs are processed through payroll and include base salaries and additional pay programs, such as sign-on bonuses and premium pay. For employees' base salaries, the Board established pay structures with salary ranges that have a minimum and maximum amount for each grade level. The Board also offers premium pay to wage employees and to those in certain job functions, such as the Board's Law Enforcement Unit and Protective Services Unit. Premium pay includes overtime, Sunday earnings, holiday earnings, and night shift differential pay.

Many of the Board's benefits programs are processed through payroll deductions and additions. Payroll deductions, such as employee retirement contributions and health insurance premiums, decrease the amount of an employee's paycheck. Payroll additions, such as the Board's health care stipend, which is available to employees to help offset the cost of health insurance premiums, increase the amount of an employee's paycheck.⁶

The Board has established internal policies to govern its compensation and benefits programs, including its *Cash Compensation Program* policy, *Overtime and Other Forms of Premium Pay* policy, and *Alternate Work Arrangements* policy.

Roles and Responsibilities

The Division of Financial Management's Payroll function is responsible for the Board's payroll processing and administers, controls, and coordinates the biweekly payroll cycle and conducts relevant tax withholding and reporting. The Division of Management's Human Resources function includes the Compensation and Benefits sections, which are responsible for overseeing the Board's compensation and benefits programs, respectively.

Controls Over Certain Payroll Processes

To minimize risk during payroll processing, the Payroll function has instituted several information technology controls, including the following:

- validation reports to identify discrepancies between payroll files
- recalculation reports to ensure the accuracy of payroll files
- access controls to ensure that personnel have permission-based access to the payroll system

In addition, Payroll runs a series of reports throughout the pay cycle to identify any potential issues. Payroll follows up with Compensation as needed on items such as incomplete job actions or unusual salary adjustments, and with employees on items such as tax withholding. Payroll staff run the initial reports, and the Payroll manager approves and signs off on the reviews. These reports accomplish the following:

- confirm that job actions during the pay cycle have been approved

⁶ The Board provides a health care stipend to employees who are enrolled in the Federal Employees Health Benefit Program through the Board to help offset the cost of medical insurance premiums. The stipend amount depends on whether the employee enrolls in single, self-plus-one, or family coverage.

- confirm that employees receiving premium pay are eligible
- confirm that premium pay is accurate and correctly allocated
- summarize employee deductions or identify employees without deductions
- recalculate year-to-date tax reporting

Payroll has also developed a series of procedures documenting its processes for biweekly payroll processing.

Oversight of Payroll Processes

The Division of Financial Management’s Compliance and Internal Control function performs quarterly internal controls testing to reduce the risk of material misstatements in the Board’s financial statements. This testing includes Payroll’s key controls, such as review and approval of premium pay, validation reports to finalize payroll, and signoffs to confirm payroll. During our scope period, the Compliance and Internal Control function found that Payroll’s key controls were operating effectively.

The Board’s independent public accountant also reviews aspects of Payroll’s biweekly payroll processes as part of the Board’s annual financial statement audit. The independent public accountant tested certain processes for new hires, separations, accruals, and agency benefit contributions. The firm found that internal controls over financial reporting were operating effectively for the period January 1, 2019, to December 31, 2020.⁷

⁷ Office of Inspector General, *Board of Governors of the Federal Reserve System Financial Statements as of and for the Years Ended December 31, 2020 and 2019, and Independent Auditors’ Report*, [OIG Report 2020-FMIC-B-005](#), March 10, 2021.



Finding: Payroll Controls Are Generally Effective

The Board's payroll controls are generally effective in ensuring compliance with applicable laws, regulations, policies, and procedures. However, we identified one exception; Payroll did not detect an instance of noncompliance with the Board's compensation policy. Specifically, one employee's base salary exceeded the maximum allowed by Board policy for 5 months. The Board's *Cash Compensation Program* policy states that an employee's base salary cannot exceed the grade-level maximum and that any compensation above the maximum will be paid as a lump sum. This employee's division requested a salary adjustment that raised the employee's salary above the grade maximum; Compensation did not identify that the employee's salary exceeded the maximum during its review and approval process, and Payroll did not have a control to detect salaries above the maximum. Implementing an additional payroll control to detect similar instances can help the Board ensure that it compensates employees in accordance with its internal policies.

Payroll Controls Are Generally Effective in Ensuring Compliance With Applicable Laws, Regulations, and Policies and Procedures

The Board's payroll controls are generally effective in ensuring compliance with applicable laws, regulations, and the Board's policies and procedures. Payroll has established both automated and manual business process controls to ensure that payroll is processed accurately. For example, Payroll reviews premium pay calculations, internal job actions, and employee tax withholdings and deductions. In addition, the payroll processes are documented within Payroll's procedures. Further, our documentation review and detailed analysis, conducted to follow up on potentially unusual transactions identified through data analytics algorithms, resulted in one exception. Figures 1 and 2 summarize our aggregate-level and employee-level testing, respectively.

Figure 1. Analysis of Payroll Transactions at the Aggregate Level



Premium pay.

Employee paychecks that included premium pay were accurate.



Federal withholding rates.

The Board used the correct rates to calculate federal withholdings.



Employee deductions.

The dollar value and frequency of each deduction type were accurate and reasonable.



Fictitious employees.

The Board made payments only to individuals who are Board employees.



Employees paid before start date.

The Board did not make payments to employees before their start date.



Duplicate payments.

In 240 instances of potential duplicate payments, we did not identify any unusual or illogical occurrences, such as over 80 hours of regular pay within a pay period or three Sunday payments within a 2-week period.

Source: OIG analysis.

Figure 2. Analysis of Payroll Transactions at the Employee Level



Source: OIG analysis.

Payroll Can Implement an Additional Control to Validate Certain Salary Data

We identified one employee whose base salary exceeded the maximum allowed by Board policy. In August 2019, the employee's annual base salary was raised to an amount that exceeded the grade-level maximum by about \$1,500. Rather than receiving the amount above the grade-level maximum in a lump-sum payment as required by policy, the employee's salary remained above the maximum for their grade until December 2019, when the Board updated the values in its 2020 pay structure.

The Board's *Cash Compensation Program* policy states that the Board has salary ranges, which the Board periodically adjusts, for all grade levels. The policy also states that the amount of any salary increase

exceeding the maximum of an employees' grade-level salary range is to be paid to the employee in the form of a lump sum.

A Compensation manager explained that the employee's division initiated the salary adjustment during the Board's annual midyear review.⁸ Compensation did not identify that the adjustment raised the employee's salary above the grade-level maximum during its review process and approved the increase. Payroll did not identify the discrepancy because it relies on Compensation's control—Compensation's review and approval—and does not have its own automated control to detect out-of-range salaries. Although Compensation is responsible for ensuring that employees' salaries remain within the applicable grade-level pay range, Payroll is in a position to develop a complementary control to validate that employee salaries remain within range.

Implementing a control to detect salaries that exceed the grade-level maximum will help to ensure that Payroll complies with Board policy, which is in part meant to promote internal fairness.

Management Action

After becoming aware of our finding, Payroll developed a query to determine whether any employee's annual base salary exceeds the maximum for their grade level. Payroll added this query to its biweekly payroll process. We observed the execution of the control and found it to be effective. Further, the Board is planning to implement a new human resources and financial management system in 2022; the managers of Payroll and Compensation both stated that they intend to incorporate a related control in their respective modules. Based on Payroll's actions and our observation of the new control, we are not making a recommendation.

Management Response

In response to our draft report, the chief financial officer states that the Division of Financial Management is pleased with our audit finding and that it remains committed to continuing an effective control environment.

⁸ Each year, to promote equity, Compensation conducts a Boardwide market review of all jobs and recommends salary adjustments for employees whose salaries are below the market variance for their job family and pay grade. The divisions review the recommendations and can make changes to salary adjustment amounts before submitting the adjustment back to Compensation for approval.



Appendix A: Scope and Methodology

Our objective was to assess the effectiveness of certain payroll internal controls designed to ensure compliance with applicable laws, regulations, policies, and procedures. Our audit scope covered payroll transactions that occurred from January 1, 2019, through March 31, 2020. We used data analytics to detect potentially unusual transactions and to run general tests on categories such as premium pay, salary adjustments, tax withholdings, and payroll deductions and additions.

To address our objective, we used data analytics to test regular pay and other pay transactions.⁹ Our scope included \$498.5 million in payments to 3,112 Board employees across pay periods from January 1, 2019, through March 31, 2020. Our dataset excluded OIG employees and payments made to them. All tests included transactions within the full scope period. Several tests compared or recalculated aggregate payroll values to confirm that the relevant controls were operating effectively (aggregate-level tests). The remainder of the tests identified specific items for which we conducted additional testing and review of supporting documents (employee-level tests).

Our aggregate-level tests included the following:

- **Premium pay.** We combined the other pay dataset with a file containing payroll shift codes to identify employees who earned premium pay. We recalculated net pay, including the amount of overtime for each pay period, and matched the results to assess at an aggregate level the accuracy of Board employee paychecks that included premium pay.
- **Federal withholding rates.** We compared the tax rates Payroll used to calculate federal tax withholding to the applicable Internal Revenue Service tax rates.
- **Employee deductions.** We reviewed the total dollar value and frequency of each deduction type—for example, employee retirement contributions or health insurance premiums—and recalculated deduction totals for each employee. We reviewed the aggregate value of all deductions and considered whether any deduction types or amounts appeared unusual.
- **Fictitious employees.** We compared the regular and other pay datasets to a list of all Board employees to determine whether the Board made payments to any nonemployees.
- **Employees paid before start date.** We analyzed the regular and other pay datasets and the Board’s listing of current employees to identify any records of active employees whose first paycheck preceded their start date.
- **Duplicate payments.** We ran a duplicate command on the regular and other pay datasets and identified 124 potential duplicate payments within regular pay and 116 potential duplicate payments within other pay. We observed the payroll system to confirm that the payments accrued on a weekly basis and therefore can appear twice within a 2-week pay period. We reviewed the complete lists of potential duplicate payments to identify any potentially unusual or illogical

⁹ *Other pay* includes overtime, weekend earnings, bonuses, and health care stipends.

occurrences, such as over 80 hours of regular pay within a pay period or three Sunday payments within a 2-week period.

Our employee-level tests included the following:

- **New employees' sign-on bonuses.** We filtered the other pay dataset to identify all sign-on bonuses. We reviewed the approval documentation for all 57 employees who received a sign-on bonus to determine whether each sign-on bonus complied with Board policy.
- **Employees with 50 or more hours of overtime in a pay period.** We filtered the other pay dataset to identify employees paid for working 50 or more hours of overtime during a 2-week pay period. We reviewed the supporting documentation for all 15 instances when an employee worked 50 or more hours of overtime during a 2-week period to determine whether they were approved in accordance with Board policy.
- **Unauthorized employees receiving premium pay.** We filtered the other pay dataset to identify 15 employees who received premium pay but appeared to be ineligible based on their job categories. We reviewed supporting documentation to determine whether these employees were authorized to receive premium pay.
- **Out-of-range salaries.** We combined the employee salary files and the grade-level descriptions and compared employee salary to the maximum salary rate. We identified 39 employees whose base salaries appeared to exceed the maximum for their grade level. We reviewed the supporting documentation to determine whether employee salaries complied with Board policy.
- **Employees paid after termination.** We compared the Board's terminated employee dataset to the Board's regular and other pay datasets and identified 15 payments made to employees after their separation date. We reviewed the supporting documentation for these payments to determine whether they were appropriate.
- **Health care stipends.** We filtered the other pay dataset to identify employees with pay that contained health care earning codes. We then applied a logical test to extract 41 employees who appeared to receive more than the allowable stipend within a pay period. We reviewed the supporting documentation to determine whether the health care stipends complied with Board policy.

We performed data analytics tests to identify 246 employees with a home address state that does not match their tax filing state, as well as 126 employees with no federal tax deductions and 173 employees with no nontax deductions. We did not perform further testing because Payroll informed us that it generally does not override employees' elections and Payroll is not required to follow up with employees about their withholdings and benefit elections.

Further, we filtered the active employee dataset to identify 44 employees participating in the Board's part-time program. Part-time salary and benefit reductions are automatically calculated based on the employee's settings in the Human Resources system of record. We did not perform further testing because the part-time salary and benefit reductions are an automated component of biweekly payroll processing.

To address our objective, we also

- reviewed applicable and relevant federal laws and regulations pertaining to the Board's payroll processes, including the Federal Reserve Act, the Tax Cuts and Jobs Act of 2017, and the Fair Labor Standards Act of 1938, as amended
- reviewed Board policies, procedures, guidance, and other relevant documentation, including its *Cash Compensation Program* policy, *Overtime and Other Forms of Premium Pay* policy, *Alternative Work Arrangements* policy, *Premium Pay Claims Guidance*, as well as the Board's salary structures
- performed walkthroughs of the Payroll manager's supervisory review process, the Payroll function's tax withholding process, and the Compliance and Internal Control function's testing of payroll controls
- interviewed Payroll employees to obtain insights into the Board's payroll functions and Human Resources employees to understand the Board's Compensation and Benefits functions
- reperformed the Compliance and Internal Control function's testing of Payroll's key controls within our scope
- considered the scope of the annual independent public accountant's financial statement audit in designing our testing

We obtained payroll and employee data from the Board's Division of Management. We observed a Division of Management employee extract the requested data and verified the completeness of the data we received.

Auditing standards require that we assess internal controls significant to our audit objective. Accordingly, we assessed certain internal controls related to the Board's Payroll function. Our assessment included reviewing laws, regulations, Board policies, and Board procedures applicable to the Board's payroll processes. We also tested the effectiveness of these controls through data analytics, as described above. The results of our assessment of internal controls are presented in the body of this report.

We conducted this audit from May 2020 to April 2021 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Appendix B: Management Response



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

DIVISION OF
FINANCIAL MANAGEMENT

May 27, 2021

Ms. Cynthia Gray
Assistant Inspector General for Audits and Evaluations
Office of Inspector General
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Ms. Gray:

Thank you for the opportunity to review and comment on the Office of Inspector General's draft report, titled *The Board's Payroll Controls are Generally Effective*. We appreciate the OIG's partnership with the Division of Financial Management over the course of this audit.

We are pleased that your audit found that the Board's payroll controls are generally effective in ensuring compliance with applicable laws, regulations, policies, and procedures. The Division of Financial Management has worked hard to operate a payroll function with effective controls, and we remain committed to continuing an effective control environment.

Thank you for your review.

Sincerely,

A handwritten signature in black ink that reads "Ricardo Aguilera".

Ricardo A. Aguilera
Director and Chief Financial Officer

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Report Contributors

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