

## **Back to Basic – Cash Flow Statement and Payroll Fraud**

Cash is king in any Business. To understand the flow of cash in the business, from where the fund is sourced and where it is disbursed, it is also crucial to monitor and identify the possibility of fraud/misuse of the incoming and outgoing funds. As an internal auditor, from testing and checking the processes of each of the businesses and controls built or embedded, it is also mandatory to check the fund's movement in each of the processes to identify any possibility of fraud/misuse. In the financial statement, the cash flow statement is presented which depicts cash flow from operating, investing, and financial activities.

- Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Cash payments to and on behalf of employees is one of the cash flow activities to determine cash flow from the operating activity (+/-). In this article, the possibility of fraud or misuse of funds involved in the payroll cycle can be identified from the cash payments to and on behalf of the employee's cash flow reported in the cash flow statement.

<b>Operating Activity</b>	Value in USD		
	Year 2021	Year 2022	Variance
Cash payments to and on behalf of employees	(8,453,421)	(9,431,541)	(978,120)

It can be seen from the above activity of cash payments to and on behalf of the employees, there is a variance of USD (978,120) as compared to the year 2021. The possibility of variance could be due to one or many of the following points and could be due to fraud in the payroll cycle.

The number of employees: Opening, movement (Joined, transferred, removal, and resignation), and closing number of employee numbers are reconciled. Possible Fraud: Ghost employees.

Pay Changes: Pay changes upward and downward as compared to the previous year for each employee is factored into the payroll. Possible Fraud: Excess/Short payment or incorrect payment.

Employee Bank Account: Ensure to check the employee bank account numbers and reconciled them with employee numbers and arrangements agreed upon with the bankers for positive and reverse positive pay control. Possible Fraud: Ghost employee fraud involving management-controlled accounts.

Withholding Tax: Withholding tax and other statutory deductions from the employee account is deposited timely to the authority. Possible Fraud: Funds misuse by not depositing the employee share and float maintained for a time being.

Bonus, Compensation, Retirement: Payments of bonus, compensation, and retirement to employees are accurately calculated and paid. Possible Fraud: Ineligible and excess payments.

Functional Department Reconciliation: The number of employees are reconciled with each department/functional level. Possible Fraud: Employee separated or resigned still considered as a present employee.

Revenue per Employee: Revenue for each of the employee is measured and any changes (+/-) is justified. In the case of the service industry, each of the billable resources is measured. Possible Fraud: Revenue and cost mismatched.

Output per Employee: Output in the case of the manufacturing industry is measured and reconciled to the payroll. Possible Fraud: Mismatch in output per employee as compared to the employee's count and cost.

Productive/Non-Productive Capacity: The capacity in terms of hours for the productive employee is rational to the employee numbers vis-à-vis non-productive employees. Possible Fraud: Ghost employees.

Employee Master Changes: Employee master changes to the critical fields are justified and documented and an appropriate audit trail is logged. Possible Fraud: Inaccurate processing of payroll.

Attendance/Employee Log/Time Sheet: The attendance record or employee log is recorded and reconciled with the payout. Possible Fraud: Ghost employees.

System Interface: The interface between the payroll systems should reconcile to maintain the integrity of data processed and manual intervention is minimized in the process. Possible Fraud: Management override of the system access.

File Upload: Manual file upload in the payroll should be with data integrity, and results are checked and verified for accurate processing. Possible Fraud: Benefits to a certain category of employees.

System Logic: System logic to process certain payouts (leave pay, overtime, retirement benefits, and deductions) should be intact and any changes to the logic should be tested and documented. Possible Fraud: Cost overstatement.

Financial Posting: Posting of payroll should be to a standard chart of accounts with defined cost centers. Possible Fraud: Mismatch of cost centers expenses and subsequent journal entries.

Payroll Cost in Income Statement: Reconcile payroll cost in the income statement with payment to employees, +/- the difference is justified. Possible Fraud: Understatement/Overstatement of payroll cost.

Payroll Liability in the Balance Sheet: Payroll provision in the balance sheet is in line with the average payroll cost and any deviation +/- to the average should be justified. Possible Fraud: Overstatement/Understatement of Liability.

Drill Down of Payroll Payout: The payout should be drilled down for all the heads such as basic pay, leave pay, overtime, bonus, retirement benefits, loans/advances, and other allowances to match the final amount to the cash flow. (Gross to Net or Net to Gross) Possible Fraud: Other payments linked to the payroll.

The above points are not exhaustive to reconcile/trace the variance in the cash flow of payout reported in the cash flow statement, there could be more reasons for such variance. To identify the chances of fraud involved is depend on individual auditor experience and the nature of the industry being audited.